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IS TAX LEGISLATION EFFECTIVELY DISCOURAGING EMPLOYEE SHARE OWNERSHIP?

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ABSTRACT

Share incentive schemes have been used for many years as a mechanism to compensate, retain and attract talent by offering employees a stake in the business. Share incentives, however, usually contribute an increasingly larger portion of executive pay in comparison with general employees. The motive for larger share incentive based compensation is on the foundation that management must have a skin in the game in order for their interest to be appropriately aligned with shareholders.

The Treasury and the South African Revenue Service ('SARS') have historically viewed share incentive schemes with suspicion. Treasury and SARS consider these schemes as salary conversion plans designed avoid tax. This has led to a litany of tax legislation that has sought to combat this so called avoidance. As things stand it appears the legislation is far too reaching and no longer reflects the commercial and economic reality of an increasingly entrepreneurial world.

The aim of this research report is to ascertain whether the current tax policy is effectively discouraging employee share ownership. This paper will consider the impact of the current tax provisions on share incentive schemes for both the employees and their companies'. The United Kingdom offer tax advantages for employee share ownership plans thus the report will also include a comparison with the tax legislation governing share option schemes in the UK. The comparison will aid in recommending a more sensible and equitable way forward with regards to the taxation of share incentive schemes in South Africa.

Key words:
Share incentive plans, Section 8B, Section 8C, executive remuneration, equity based compensation

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

Allon Joel Isaacman

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Chapter 1: Introduction

1.1. Background

A share incentive scheme can be described as a type of financial incentive plan where employees are given the opportunity to acquire shares in the company in which they work. Generally the shares are offered by the company at an advantageous price.

The use of share incentive schemes as part of corporate remuneration schemes and talent management strategies has become commonplace.[1] This allows selected employees to share in the growth of the corporate entity in which they are employed. These schemes have also been used as a mechanism to compensate, retain and attract talent by offering employees a stake in the business.

These incentives also assist in aligning the interests of shareholders and executive management. The philosophy behind this rationale is located in 'agency theory'. Agency theory focuses on the problems that arise when the goals of the principal and the agent are in conflict.[2] The agency relationship exists between the agent (management) and the principal (shareholders) of the corporate. Agency theory assumes that agents would generally act to promote their own interests[3] and that they would not tend to the company's affairs with the same attentiveness that the principal would have done.[4]

Shareholders and managers may have divergent interests. This is due to the shareholder's objective of value maximisation being in conflict with the managers' objectives. Managers would not be concerned with maximising shareholder value, as there is no direct benefit accruing to them. Managers would likely be concerned with their own self-interests and maximising their position within the entity.

Along with aligning shareholder and manager interests, share incentive schemes have other key benefits. These include improved cash flow management as instead of cash

[1] Leape, E. (2006). *Managing the Skills Shortage*. *Canadian Manager*, Winter, 4-7.
[2] Eisenhardt, K.M. (1989). *Agency theory: an assessment and review*. *Academy of Management Review*, 14(1), 57-74.
[3] Ibid.
[4] Smith, A. (1892). *An inquiry into the nature and causes of the wealth of nations*. London: Routledge. (Original work published 1776).

remuneration or bonuses the employees will received equity based remuneration, freeing up cash to utilise elsewhere in the business. Employees also benefit through receipt of dividends and a capital realisation if there is a gain in the price of the shares.

The gain mentioned above is essentially what the National Treasury and SARS wish to tax. Section 8C of the Income Tax Act ('the Act') was first introduced in order to replace the old Section 8A. In the Explanatory Memorandum on the Revenue Laws Amendment Bill (2004: 10) the National Treasury and SARS reasoned that:

> The existing section 8A, enacted in 1969, has failed to keep pace with the myriad of equity-based incentives developed for top management.… The regime also fails to fully capture all the appreciation associated with the marketable security as ordinary income.

The focus of taxing share incentive schemes shifted from the date of the 'right to acquire' shares to the date of the shares 'vesting'. This resulted in effectively 'section 8C taking a very literal and strict approach to equity-based compensation – it is remuneration, so tax it.'[5] Section 8C seeks to tax the full gain realised as income at vesting date. Section 8C was successful in limiting tax advantage gain under the old section 8A however, through clever tax planning, employees and their companies were still able to obtain tax advantages. As soon as a lacuna was identified however, Treasury and SARS sought to close it. This resulted in a multitude of amendments to section 8C in addition to the introduction of specific provisions governing the taxation of dividends and capital gains that relate to share incentive schemes.

The evolution of tax provisions has resulted in legislation that is far too reaching and no longer reflects the commercial and economic reality of an increasingly entrepreneurial world. Executives and employees, to a lesser extent, who receive equity based compensation are effectively investing alongside shareholders and are exposed to the same market risk. Shareholders are generally rewarded for assuming the risk with lower tax rates. 'The tax system principally encourages and rewards risk-taking with lower tax rates, as is the case for capital gains and dividends. This principle however is not reflected in how share incentives are taxed[6]

[5] Foster, D. (2016). *Executive share incentives at the crossroads.*
[6] Ibid.

1.2. The Research Problem

1.2.1. The Problem Statement

The research will examine whether current tax legislation is discouraging employee share ownership through a critical analysis of the current and certain proposed tax amendments.

1.2.2. The Sub-Problems

1. The first sub-problem is to evaluate the impact of current taxation provisions on employees and whether the provisions are a reflection of the economic reality.

2. The second sub-problem is to examine the deductibility of share incentive scheme expenses for the corporate entities.

3. The third sub-problem is to examine the tax legislation governing share option schemes in the UK. The examination will include an analysis of the tax advantages and incentives in the UK compared to South Africa.

1.3. Research Methodology

The research method followed in this study consists of a literature review. Current income tax legislation, journal articles, legal judgments, dissertations and media studies will be utilised as part of the literature review.

1.4. Scope and Limitations

The scope of this research report will look into the tax considerations, important concepts and motivation for offering employees shares in the business they work for. The focus is on generic tax issues that may affect employees and the companies, for which they work for, as well as legislation, case law, and other tax issues.

In analysing the tax effects on scheme participants as well as the companies establishing the schemes, the investigation for the purposes of this study will be limited to legislation contained in the Act. No reference will be made to any other tax levied by SARS that is not specifically included in the Income Tax Act 58 of 1962.

Share schemes are subject to many other issues which are unrelated to tax. The focus however, of this research report is on the tax effects, thus the unrelated issues will be but will not be dealt with in depth.

1.5. Chapter Outline

1.5.1. Chapter 1: Introduction

This introductory chapter will introduce the background and include a synopsis of share incentive schemes and their significance in the context of employee remuneration. This chapter will also discuss the significance of the research, the problems and sub-problems identified and the research method used.

1.5.2. Chapter 2: Functioning of Share Incentive Schemes

This Chapter will consider what a share incentive scheme is. The chapter will detail the basic mechanisms which determine the type of share incentive scheme. The chapter will further examine the common types of schemes in operation in South Africa.

1.5.3. Chapter 3: Motivation of Share Incentive Schemes

The focus of this chapter will be the rationale behind why employers offer employees the opportunity to participate in these schemes. This will be corroborated with reference to research conducted, both globally and locally.

1.5.4. Chapter 4: Tax Implications on the Participants of the Share Incentive Schemes

In this chapter an examination of the tax legislation in the Act relevant to the participants (employees) of the schemes will be performed. Specific attention will be given to section 8C as well as the relevant Eighth Schedule paragraphs. The tax implications of proposed amendments to the Act, which impact share incentive schemes, will also be considered.

1.5.5. Chapter 5: Deductibility of Share Incentive Scheme Expenses

In this chapter an examination of the tax legislation in the Act relevant to the employers who fund and set up the scheme will be performed. Specific attention will be given to section 11(*a*) as well as the relevant case law. Rulings in relation to the deductibility of share incentive scheme costs in two Binding Private rulings will also be discussed.

1.5.6. Chapter 6: A Critical Comparison of the Taxation of Employee Share Incentives Schemes in the UK and South African

The objective of this chapter will be to critically compare the taxation of share incentive schemes in the United Kingdom ('UK') and South Africa. The chapter will firstly give an overall understanding of how employee stock ownership plans ('ESOPS') are set up in the UK and basic mechanisms around these plans. Section 8B of the Act will also be discussed. The chapter will then identify material differences and aspects of the UK tax system that could be applied to improve the South African tax system for share incentive schemes.

1.5.7. Chapter 7: Conclusions and Recommendations

This final and concluding chapter will summarise the pertinent findings of the previous chapters. The chapter will provide a conclusion to the findings in terms of the research questions. The limitations of this research will furthermore be discussed, and areas of future research will be identified. In closing, the chapter will provide concluding remarks and possible recommendations that may have come to light throughout the conducting of the research report.

Chapter 2: Functioning of Share Incentive Schemes

2.1. Introduction

A share incentive scheme also known internationally as an employee share plan can be defined as an employee benefit scheme intended to motivate employees by giving them a stake in the firm's success through equity participation.[7]

Share incentive schemes have been utilised for many years in remunerating employees within organisations. Share incentives form part of variable pay in the overall package of employees and provide employees with direct or indirect ownership in the company.

The structure of share schemes has evolved over time with many variations. Plans typically involve the acquisition of shares by the employees directly or by a fund with the employees then becoming beneficiaries of the fund.[8] The most common types utilised in South Africa are share option schemes, share purchase schemes, deferred implantation schemes (also referred to as deferred delivery schemes) and phantom share schemes.

2.2. Key Terms and Features of Share Schemes

The evolution of share schemes has become increasingly complex over time which has led to simple share option schemes mutating into increasing complex schemes such as phantom share schemes. This it can be argued is as a direct result of increasingly complex and punitive tax legislation targeting these schemes. Through the evolution of complexity however, all share schemes have common features which vary depending on how the schemes are structured.

2.2.1 Share Incentive Trust

A trust is the most common mechanism utilised by employers when implementing share incentive schemes. A trust is a legal institution in which a functionary, the trustee, is entrusted to manage the trust's affairs separate from his or her own for the

[7] Business Dictionary (2016).

[8] Gad, R. Coetzee, A. Farrand, H. Speirs, S. and Ellis, E. (2010) *2009/2010 Cross-border Labour and Employee Benefits 2009/10 Handbook: Volume 2: Employee Share Plans*, 139 – 144.

benefit of another, in other words the beneficiary.[9] The trust's primary purpose is to act as conduit between the company and its employees. The main responsibility of the share trust would be to hold shares for the benefit of the employees selected to participate in the share incentive scheme.

The trustees are responsible for the administration and management of the share trust. The trust deed outlines the responsibilities of the trustees as well as the terms and conditions which govern the scheme.

The use of a trust has a few advantages which include:

- Terms and conditions in the trust deed can be used as a tool retain employees and limit costs should the employee be dismissed or resign shortly after acquiring shares; and
- The company can maintain control over shares, while at the same time the Trustee has a fiduciary duty to employees, providing greater transparency and integrity to the arrangement;[10]

The implementation of a trust begins with the company establishing an *inter vivos*, between the living, employee share incentive trust. Once established, the trust will either purchase shares on the open market or the company will issue them directly to the trust.

In order to finance the purchase of the shares the trust will borrow money from the company. This is usually done by the trust issuing preference share funding. There are certain Companies Act[11] provisions which need to be complied with. This will be dealt with under the subheading 'Companies Act considerations' below.

Depending on which scheme is implemented, the trustees will either grant options or make offers to employees to purchase shares (or make provision for both).[12] Depending on the circumstances of the employees they may either pay cash or the

[9] Cameron, E. (2002). *Honoré's South African Law of Trusts 5 ed*. 17; Honoré, A. M. A G Guest *Oxford Essays in Jurisprudence.* 144.
[10] Hutt, A. (2016). *Employee share schemes – a question of trust.*
[11] Companies Act, 2008 (Act No. 71 of 2008).
[12] Butler, E.E. 2005. *Employee Share incentive Schemes – The taxation of the old and the "new".* Cape Town: University of Cape Town (H.Dip (Taxation): Technical Report), 13.

purchase price may be owing to the trust on loan account. Any dividends received by an employee are utilised to settle the employee's liability to the trust. When the employee pays the purchase price of his shares or his share loan to the trustees, the latter utilise the funds to repay the trust's loan from the company.[13]

2.2.2 Vesting and vesting conditions

An important concept in determining the tax effects of section 8C is the understanding of when vesting occurs in terms of the share incentive plan.

Vesting is the process by which an employee accrues non-forfeitable rights over employer-provided stock incentives.[14] The vesting date is the date all the vesting conditions have been satisfied and the employee has rights to the shares granted.

Vesting conditions are defined in International Financial Reporting Standards 2 Share Based Payment[15] as the following:

> The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share based payments arrangement...

Vesting conditions are essentially conditions which need to be fulfilled in order for the employee to obtain an unconditional right to the award under the share incentive scheme. Vesting conditions can be further broken down service conditions and performance conditions.

Service conditions require the counterparty to complete as specified period of service.[16]For example, a condition could include that an employee will need to stay in employment with the company for a minimum of 3 years from grant date of the options.

Performance conditions require the counterparty to complete as specified period of service and specified performance targets to be met.[17] Borrowing from the example

[13] Ibid.
[14] Investopedia, (2016)
[15] IFRS Foundation. (2012). *A Guide Through IFRS. International Financial Reporting Standards 2 Share Based Payments,* A116.
[16] Ibid.
[17] Ibid.

above, a condition could include that employee will need to stay in employment with the company for a minimum of 3 years from grant date of the options and over the period headline earnings per share is required to increase by 50%.

2.2.3 Cash settled and equity settled share incentive scheme transaction

Companies generally will choose either to grant employees the right to acquire actual shares or grant the employee a right to cash which is based on the price of a specific share. There are advantages and disadvantages to both types of settlement.

Advantages to cash based settlement include the non-dilution of the holdings of existing shareholders in the business. A disadvantage however, is that the company will have to utilise existing cash to settle the scheme which would have otherwise been utilised in the expansion of the business. Advantages to equity based settlement include giving employees an ownership interest in the business. A disadvantage however, is the dilution of the holdings of existing shareholders in the business which can negatively impact the share price.

2.2.4 Companies Act considerations

Prior to the introduction of the new Companies Act[18], there were provisions against companies providing financial assistance for the purchase of shares in itself. The use of an *inter vivos* share trust was a technique to legally avoid these provisions. Under section 38 and section 226 of the old Companies Act[19], a company was not prohibited from providing financial assistance to a share trust for the purchase of shares in itself.

The introduction of the new Companies Act amends the prohibition against the granting of financial assistance to share incentive schemes. Section 97 governs these requirements as they relate to employee share schemes. Section 95(1)(c) of the new Companies Act defines an 'employee share scheme' as;

> …a scheme established by a company, whether by means of a trust or otherwise, for the purpose of offering participation therein solely to employees, officers and other persons closely involved in the business of the company or a subsidiary of the company, either—
> i) by means of the issue of shares in the company; or
> ii) by the grant of options for shares in the company;

[18] Companies Act, 2008 (Act No. 71 of 2008)
[19] Companies Act 61 of 1973

Section 97 allows for certain prohibitions to be lifted. Section 97 allows directors to authorise the company to provide financial assistance under an employee share incentive scheme and shareholder approval as contemplated in section 41 will not be required. Section 97 further lifts the prohibitions placed on financial assistance for the subscription in securities as contemplated in section 44. The prohibitions against loans or other financial assistance to directors contemplated in section 45 also is lifted.

In order for the restrictions to be lifted, the provisions under section 97(1) need to be adhered to. Section 97(1)(a)(i) requires that a compliance officer be appointed to be accountable to the directors of the company. Section 97(1)(a)(ii) further requires that the company states in its annual financial statements, the number of shares it has allocated during the financial year in terms of its employee share scheme.

Section 97(1)(b) requires that the compliance offer complies with certain requirements under section 97(2) which states:

> (2) A compliance officer who is appointed in respect of any employee share scheme—
>
> a) is responsible for the administration of that scheme;
>
> b) must provide a written statement to any employee who receives an offer of specified shares in terms of that employee scheme, setting out—
>
> i) full particulars of the nature of the transaction, including the risks associated with it;
>
> ii) information relating to the company, including its latest annual financial statements, the general nature of its business and its profit history over the last three years; and
>
> iii) full particulars of any material changes that occur in respect of any information provided in terms of subparagraph (i) or (ii);
>
> c) must ensure that copies of the documents containing the information referred to in paragraph (b) are filed within 20 business days after the employee share scheme has been established; and
>
> d) must file a certificate within 60 business days after the end of each financial year, certifying that the compliance officer has complied with the obligations in terms of this section during the past financial year.

2.3. Common Types of Share Scheme Structures

2.3.1 Share Option Schemes

The share option scheme is a simple scheme in its design and functioning. Employees are granted options to acquire shares in the company or another company within the same group of companies. The options are either granted by the company itself or in the majority of schemes by a share trust. The option gives the employee a right but not an obligation to acquire a fixed number of shares at a predetermined price. The option price is usually the market price at the grant date. The exercise price can be less than the market value of the shares at the date of grant.[20]

The options granted to the employee are usually exercisable over a time period, the most common being 3 to 10 years. An employer may also attach certain performance conditions which would be required to be met in order for the employee to exercise their options. The options will lapse if the employee resigns or is terminated by the company. An employee will also have a certain time limit within which the employee needs to exercise the options otherwise they will lapse.

The employees do not acquire the shares or earn any dividend income and there is no obligation to pay the purchase or subscription price of the shares until the employees exercise the option.[21]

2.3.2 Share Purchase Schemes

Under a share purchase scheme an *inter vivos* share trust is set up. The trust is set up for the benefit of the company's employees. The share trust will purchase or subscribe to shares of the company. Employees are then given the opportunity to buy shares at the market value at the date the offer is made to them. The trust will grant the employees a loan to finance the purchase of the shares. The participating employees will only be required to pay for the shares at a specified future date. Usually the employee will pay in tranches over 3 to 5 years. The loans are usually granted at

[20] Gad, R. et al (2010) *2009/2010 Cross-border Labour and Employee Benefits 2009/10 Handbook: Volume 2: Employee Share Plans*, 139 – 144.
[21] Butler, E.E. (2005). *Employee Share incentive Schemes – The taxation of the old and the "new".* Cape Town: University of Cape Town (H.Dip (Taxation): Technical Report), 15.

market related interest rates and terms however, if an interest free loan were to be granted, additional tax implications will arise for the employee.

As the shares have been sold to the employee all the rights and benefits associated with share ownership will vest in the employee. Dividend income that may accrue to the employees on these shares, will firstly be used to pay employees tax on the loan and, secondly, to pay interest (if any) on the loan.[22]

The company may impose restrictions that are only removed when performance or time-based vesting conditions are met. If these conditions are not met it may result in the acquisition agreement ceasing to have effect. Alternatively, payment for and delivery of the shares may be conditional on the employee's fulfilment of conditions. If so, if the employee fails to fulfil the conditions, the acquisition agreement is cancelled or the shares are repurchased by the company.[23]

After the qualifying period, employees may either continue to hold the shares or sell the shares back to the trust at the then market value.

2.3.3 Deferred Implementation Schemes

Deferred implementation schemes are issued under same conditions as share purchase scheme.[24] The employer, or share trust, will grant employees the option to acquire a number of shares at a fixed price on a specified date in the future through the use of a contract.[25] Payment for the delivery for the shares is deferred over a certain period usually 3 to 10 years. The purchase price is the market price at the date of the conclusion of the contract. The full purchase price of the shares must be paid in full by or on the date of the delivery of the shares.

The option must be exercised within a short period after the granting thereof. If the option is not exercised timeously, the option lapses. [26]

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[22] Ibid.
[23] Gad, R. et al (2010) *2009/2010 Cross-border Labour and Employee Benefits 2009/10 Handbook: Volume 2: Employee Share Plans*, 139 – 144.
[24] Nyelisani, T.P. (2010). *Employee perceptions of share schemes*. Pretoria: Gordon Institute of Business Science, University of Pretoria (Master of Business Administration: dissertation), 21.
[25] Butler, E.E. (2005). *Employee Share incentive Schemes – The taxation of the old and the "new".* Cape Town: University of Cape Town (H.Dip (Taxation): Technical Report), 16.
[26] Ibid.

Prior to the delivery of the shares and the payment of the purchase price the employee receives no dividends or other benefits attached to the shares.[27]

The main difference between the deferred implementation scheme and the share purchase scheme is the absence of a loan between the trust and the employee.

2.3.4 Phantom Share Schemes

A phantom share scheme is different to traditional share incentive schemes as no actual physical shares are issued to employees. Units are allocated to employees either by the company or through the use of a share trust. As these units are not actual shares it does not entitle employees with any rights in relation to share ownership. The scheme amounts to a contract between the company or share trust and each employee whereby the employee receives what is, effectively, a bonus.[28]

The units in the phantom share scheme often have two rights attached to it, namely the right to receive dividends and the right to participate in the appreciation or growth of the company (share appreciation rights).[29] These rights make phantom share schemes a useful mechanism that companies can use to incentivise their participants in order to align the participant's objectives with that of a shareholder.

Upon the expiry of certain time periods, the holder of a unit is paid an amount equal to the market value of an actual share or the growth in the market value since the allocation date of the unit.[30]

2.4. Conclusion

The structure of share schemes has evolved over time with many variations. This evolution has come hand in hand with the evolution of tax legislation. The evolution has led to very complex schemes which are subject to ever increasingly complex tax

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[27] Ibid.
[28] Ibid.
[29] Jonas, S. (2012). *A Critical Analysis of the Tax Efficiency of Share Incentive Schemes in Relation to Employees in South Africa.* University of Pretoria (Masters Degrees (School of Accountancy)), 42.
[30]Butler, E.E. (2005). *Employee Share incentive Schemes – The taxation of the old and the "new".* Cape Town: University of Cape Town (H.Dip (Taxation): Technical Report), 18.

legislation. There are four main types of share incentive schemes in South Africa namely share option schemes, share purchase schemes, deferred implantation schemes and phantom share schemes. The structure selected by the company will depend on what the company wishes to achieve through its implementation.

Chapter 3: Motivation of Share Incentive Schemes

3.1. Introduction

The use of share incentive schemes as part of corporate remuneration schemes and talent management strategies has become commonplace.[31] Share incentive schemes have traditionally been used as a mechanism to compensate, retain and attract talent by offering employees a stake in the business. By offering employees a stake in the company they work in it provides them an opportunity to grow with the company and share in the wealth the company generates. Share incentives also assist in aligning the interests of shareholders and executive management.

3.2. Agency Theory

The misalignment of shareholders interest and those of management is based on 'agency theory'. The agency theory was established by Jensen and Meckling in 1976. Jensen and Meckling (1976) argued that the separation of ownership and control has resulted in an agency problem as the managers who act as agents might not always act in the best interests of the shareholders or owners, who are the principals of the firm.[32]

Agency theory focuses on the problems that arise when the goals of the principal and the agent are in conflict.[33] The agency relationship exists between the agent (management) and the principal (shareholders) of the corporate. Agency theory assumes that agents would generally act to promote their own interests[34] and that they would not tend to the company's affairs with the same attentiveness that the principal would have done.[35] Shareholders and managers may have divergent interests. This is due to the shareholder's objective of value maximisation being in conflict with the managers' objectives. Managers would not be concerned with maximising shareholder value, as there is no direct benefit accruing to them. Managers

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[31] Leape, E. (2006). *Managing the Skills Shortage. Canadian Manager*, Winter, 4-7.
[32] Jensen M, &Meckling W. (1976). Theory of the firm: Managerial behavior, agency costs, and ownership structure. Journal of Financial Economics 3: 305 – 360.
[33] Eisenhardt, K.M. (1989). *Agency theory: an assessment and review. Academy of Management Review*, 14(1), 57-74.
[34] Ibid.
[35] Smith, A. (1892). *An inquiry into the nature and causes of the wealth of nations*. London: Routledge. (Original work published 1776).

would likely be concerned with their own self-interests and maximising their position within the entity.

Offering share incentives to management is an initiative to realign the divergent interests of shareholders and management. Management and employees would be owners of the business and this could shift their focus away from short term accounting profits to long term profitability.[36] Share incentive schemes provide employees the opportunity to share in the growth and wealth of the company which aligns the goals of shareholders, management and employees.

3.3. Retention and Talent Attraction

Share incentives schemes exist in many of today's public companies as well as in private companies. Share schemes are considered influential to recruitment of talent workforce that the company intends to attract.[37] Companies are thus structuring salary packages with the opportunity to participate in the share incentive scheme of the company.

Share incentives assist companies in the retention of employees. These schemes assist in retaining employees as the vesting periods attached to share incentive schemes discourage employees from leaving. If an employee leaves a company prior to vesting, the employee would suffer a financial loss by losing out on all the unvested options.

3.4. Productivity and Motivation

For many businesses, people are the most important asset and if they are also owners increased productivity, efficiency and profitability often follow suit.[38] An employee share incentive scheme promotes a culture of ownership. When employees invest in their company, they often find renewed purpose in the work at hand and have a greater incentive to ensure their organisation's overall success.[39]

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[36] Muurling, R. & Lehnert, T. (2004). *Option-based compensation: a survey. The International Journal of Accounting*. 39: 365-401.
[37] Nyelisani, T.P. (2010). *Employee perceptions of share schemes*. Pretoria: Gordon Institute of Business Science, University of Pretoria (Master of Business Administration: dissertation), 20.
[38] Davie, G. (2015) *Employee ownership: Another way of doing business.*
[39] Productivity SA. (2014) *Employee-share ownership a boost to productivity.*

An employee who owns shares in the company in which he or she works would logically want to see the share price rise as it would correspond with an increase in personal wealth. The employee is more likely to work harder in order to achieve this and drive his other colleagues to do the same. This could create an increase in productivity and performance as a whole and grow the company along with the wealth of all the stakeholders in the company.

A two-year study was performed by Computershare, an employee share plan services provider, together with The London School of Economics (LSE) in 2009. The study proposes that not only do share-owning employees indeed stay longer; they do in fact work harder as well.[40] The findings of the research include:

- Members of share schemes were far more likely to describe their work as 'above average' compared with non-members;
- Share scheme members were less likely to tolerate under-performance by their colleagues;
- There was demonstrably lower levels of absence among share scheme members; and
- In addition to finding that those who belong to company share schemes stay with companies longer, share plan members also say they take a greater interest in the finances of the company they work for.

The research clearly demonstrates the effect share incentives can have on employees. Employees perceive their participation in employee incentive schemes as an investment opportunity. In order to protect their investment employees are willing to protect their investment by working harder. Share incentive schemes are a key initiative in enhancing employee productivity and performance and keeping employees motivated to perform.

3.5. Conclusion

Companies implement share incentive schemes for a variety of reasons. These reasons include aligning the interest of shareholders and the interest of management and employees, attracting and retaining key employees, enhancing productivity and

[40] Crush, P. (2009) *Motivating staff through employee share schemes.*

motivating employees. The implementation of the schemes has historically led to tax benefits for participating employees. SARS has overtime implemented various provisions seeking to limit these benefits. Chapter 4 will examine the tax legislation relevant to the participants (employees) of the schemes will be performed while chapter 5 will examine the tax legislation relevant to the companies who implement the schemes.

Chapter 4: Tax Implications on the Participants of the Share Incentive Schemes

4.1. Introduction

SARS in recent years has continued to target share incentive schemes. There has been continued tightening of tax legislation governing share incentive schemes. This tightening, SARS asserts, is in order to protect the tax base against tax avoidance of disguised salary benefits.[41]

Due to the inherent complexity of share incentive schemes, many sections of the Income Tax Act have legislation specifically targeting share incentive schemes. This chapter aims to examine the tax legislation applicable to share incentive schemes, specifically the impact on individuals. In addition to current legislation recent proposals will also be examined and their likely impact determined.

4.2. Section 8C

Section 8C is the main provision of the Income Tax Act that deals with the tax treatment of share incentives for individuals.

Section 8C of the Income Tax Act was first introduced in order to replace the old Section 8A. In the Explanatory Memorandum on the Revenue Laws Amendment Bill (2004, 10) the National Treasury and SARS reasoned that:

> The existing section 8A, enacted in 1969, has failed to keep pace with the myriad of equity-based incentives developed for top management.… The regime also fails to fully capture all the appreciation associated with the marketable security as ordinary income.

The main purpose of the new section was to effectively tax directors and employees on the receipt of income from equity based incentive schemes and therefore close potential 'loopholes' that existed in the previous section 8A.[42] The focus of taxing share incentive schemes shifted from the date of the 'right to acquire' shares to the date of the shares 'vesting'.

[41] National Treasury. (2004). Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004. Pretoria: Government Printer, 20.

[42] Muller, T, C. (2010) *A critical analysis of Section 8C : taxation of directors and employees on vesting of equity instruments.* University of Pretoria (Masters Degrees (School of Accountancy)). ii

Section 8C(1) states a taxpayer must include any gain or deduct any loss from his or her income for a year of assessment in respect of the vesting during the year of any equity instrument acquired by the taxpayer if:

- By virtue of his or her employment or office of director;
- From any person by arrangement with the taxpayer's employer;
- By virtue of any restricted equity instrument held by that taxpayer;
- A restricted equity instrument was acquired during the period of his or her employment from that company or any associated institution in relation to that company; or
- A restricted equity instrument was acquired during the period of his or her employment from any employee or director of that company or associated institution.

The gain will be included or the loss deducted regardless of sections 9C and 23(*m*). The aim of the exclusion from section 9C is to ensure that the gain is taxed as income regardless of the number of years the share is held. This is to ensure that the gain is taxed as income and thus taxed at a higher effective rate.

Section 8C(2) determines how the gain or loss is calculated. The vesting of an equity instrument will result in either a gain to be included in or a loss to be deducted from the income of the employee. The gain or loss is determined as follows:

- If the disposal of the equity instrument was to the employer, an associated institution or other person by arrangement with the employer in terms of a restriction imposed in relation to that equity instrument for an amount which is less than the market value of that restricted equity instrument, the gain or loss is the amount received or accrued less the consideration paid for the instrument;
- If the disposal by way of release, abandonment or lapse of an option or financial instrument, the gain or loss is the amount received or accrued less the consideration paid for the instrument; or
- In any other case, it is the market value of the instrument determined at the time that it vests less the consideration paid for the instrument.

Key terms in determining the gain or loss in relation to the vesting of a section 8C instrument is the term 'market value' and 'consideration'. Both these terms are defined in section 8C(7). 'Market value' is defined as:

> 'market value' in relation to an equity instrument —
> (a) of a private company as defined in the Companies Act or a company that would be regarded as a private company if it were incorporated under that Act, means an amount determined as its value in terms of a method of valuation—
> (i) prescribed in the rules relating to the acquisition and disposal of that equity instrument;
> (ii) which is regarded as a proxy for the market value of that equity instrument for the purposes of those rules; and
> (iii) used consistently to determine both the consideration for the acquisition of that equity instrument and the price of the equity instrument repurchased from the taxpayer after it has vested in that taxpayer; or
> (b) of any other company, means the price which could be obtained upon the sale of that equity instrument between a willing buyer and a willing seller dealing freely at arm's length in an open market and, in the case of a restricted equity instrument, had the restriction to which that equity instrument is subject not existed;

Effectively a private company will be able to use any valuation method as long as it has been consistently used and is a common method for determining the valuation of an equity instrument. For a public company the closing market price on an exchange will be used to determine market value.

The term 'consideration' excludes services rendered or to be rendered or anything done, to be done or not to be done but includes:

- Any amount given or to be given by the taxpayer in respect of an equity instrument;
- An amount given or to be given by the taxpayer in respect of any other restricted instrument which he had disposed of in exchange for the equity instrument, reduced by any amount attributable to the gain or loss determined in terms of s 8C(4)(*b*); or
- An amount given or to be given by any person under a non-arm's length disposal or by a connected person in terms of section 8C(5)(*a*) or (*b*) in respect of that restricted equity instrument, to the extent that the amount

does not exceed the amount the taxpayer would have had to give to acquire that equity instrument had it not been disposed of or deemed to have been disposed of by him or her, but does not include any amount given or to be given by that person to the taxpayer to acquire that restricted equity instrument.

This is a situation where a connected person acquires the equity instrument the consideration deductible is limited to what the taxpayer could have deducted had he not disposed of the instrument to the connected person. This would address a situation where the taxpayer transfers the shares to a trust before they vest in him.[43]

4.2.1. Vesting

It can be noted from section 8C(1) that an important concept in the application of the section is the date of 'vesting'. No consideration is given to the date of transfer of ownership or date of delivery of the share. It is thus submitted that even if shares could be transferred to the employee before the vesting date, there would be no tax implications under section 8C.

The date of vesting will depend on the terms of the equity instrument. 'Vesting' for the purposes of section 8C is not necessarily the same as vesting in terms of the rules of the scheme (which is usually the date an employee is entitled to deal with a share).[44]

An equity instrument acquired by a taxpayer is deemed for the purposes of section 8C to vest:

- If it was an acquisition of an unrestricted equity instrument the date of vesting will be at the time of that acquisition;
- If it was an acquisition of a restricted equity instrument the date of vesting will be when all the restrictions, which result in that equity instrument being classified as a 'restricted equity instrument', cease to have effect;

[43] de Koker, A, P. Williams R, C. (2016). *Silke on South African Income Tax.* 4.73C.
[44] Ibid.

- Immediately before that employee disposes of that 'restricted equity instrument', unless that equity instrument was exchanged or disposed of to a connected person;
- Immediately after an option or financial instrument, which qualifies as an 'equity instrument', terminates (otherwise than by the exercise or conversion of that equity instrument);
- Immediately before the death of an employee if all the restrictions relating to that equity instrument are or may be lifted on or after death; and
- Disposals contemplated in section 8C(2)(*a*)(i) or (*b*)(i) occurs, which are disposals back to the employer (or associated institution or other person) by arrangement for an amount that is less than market value.

4.2.2. Restricted and unrestricted equity instruments

The understanding of what qualifies as a restricted versus unrestricted equity instrument is critical in determining the date of vesting of the equity instrument.

An 'equity instrument' is defined as follows in section 8C(7):

> 'equity instrument' means a share or a member's interest in a company, and includes—
> (a) an option to acquire such a share, part of a share or member's interest;
> (b) any financial instrument that is convertible to a share or member's interest; and
> (c) any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member's interest;

The term 'equity instrument' therefore includes shares in the equity share capital of a company, members' interests in a close corporation and options to acquire such shares and interests as well as financial instruments convertible into shares or interest, such as convertible debentures.[45] Paragraph (*c*) in the definition would include an entitlement in certain phantom share schemes.

The distinction between a restricted equity instruments versus unrestricted equity instruments is due to the nature and intention of share incentive schemes. Employers use of share incentive schemes as a mechanism to retain employees in order to achieve this, the employer will place restrictions on the equity instruments.

[45] Ibid.

The term 'restricted equity instrument' is defined in section 8C(7)as:

> …in relation to a taxpayer means an equity instrument—
>
> (a) which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;
>
> (b) which is subject to any restriction that could result in the taxpayer—
>
> (i) forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or
>
> (ii) being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;
>
> (c) if any person has retained the right to impose a restriction contemplated in paragraph (a) or (b) on the disposal of that equity instrument;
>
> (d) which is an option contemplated in paragraph (a) of the definition of 'equity instrument' and where the equity instrument which can be acquired in terms of that option will be a restricted equity instrument;
>
> (e) which is a financial instrument contemplated in paragraph (b) of the definition of 'equity instrument' and where the equity instrument to which that financial instrument can be converted will be a restricted equity instrument;
>
> (f) if the employer, associated institution in relation to the employer or other person by arrangement with the employer has at the time of acquisition by the taxpayer of the equity instrument undertaken to—
>
> (i) cancel the transaction under which that taxpayer acquired the equity instrument; or
>
> (ii) repurchase that equity instrument from that taxpayer at a price exceeding its market value on the date of repurchase,
>
> if there is a decline in the value of the equity instrument after that acquisition; or
>
> (g) which is not deliverable to the taxpayer until the happening of an event, whether fixed or contingent;

As can be seen the definition is very wide and encompasses many scenarios. Paragraph (*a*) refers to situation where, for example, an employee is prohibited from selling the equity instrument for a certain period. A further example involves deferred delivery shares, whereby the taxpayer acquires the shares at a future date for an amount due at that later date.[46]

Paragraph (*b*) refers to a situation where the employee is obliged to sell the equity instrument at cost or for no consideration.

[46] Ibid.

Paragraph (*c*) refers to a situation which may arise, for example, if a shareholder of the employer company has an option to purchase the shares at cost should the taxpayer leave his employment within a specified period.[47]

Paragraph (*d*) refers to an option to acquire a share. When the equity instrument to be acquired is a restricted equity instrument the option is treated as restricted regardless of whether the option itself is subject to any restrictions. Similarly paragraph (e) refers to a financial instrument other than an option that is convertible to a share, part of a share or member's interest. The financial instrument, such as a debenture, is treated as restricted regardless of whether it is itself is subject to any restrictions.

Paragraph (*f*) refers to the case where a provision is inserted where the employer guarantees to repurchase the shares above market value if the share price drops to a certain level.

An 'unrestricted equity instrument' is defined as an equity instrument which is not a restricted equity instrument. As per Interpretation Note number 55, the distinction between an unrestricted equity instrument and its restricted counterpart is important as it determines the timing of the taxable event.[48]

4.2.3. Deemed acquisition

Deemed acquisitions are dealt with under section 8C(4). Section 8C(4) is essentially an anti-avoidance provision. Where an employee disposes of a restricted equity instrument for an amount consisting of or including another restricted equity instrument in his employer or an associated institution, the new instrument is deemed to be acquired by virtue of his employment or office of director. If the amount includes payment in a form other than a restricted instrument, the payment less any consideration attributable thereto is deemed to be a gain or loss. This gain or loss must be included in or deducted from the income of the taxpayer in the year of assessment during which the original instrument is disposed of.

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[47] Ibid.

[48] National Treasury. (2011). *Interpretation Note No. 55* (Issue 2). Pretoria: Government Printer, 2.

4.2.4. Transfer of the equity instrument

Another anti-avoidance provision lies within section 8C(5). This provision is designed to prevent transfers which could result in a reduction of the amount of the gains by artificially triggering tax at an earlier date, that is, before the appreciation of the instrument is fully realized.[49]

If a restricted equity instrument which was acquired by an employee is disposed of by that taxpayer to any person in terms of a transaction at non-arm's length or who is a connected person in relation to that taxpayer, the determination of any gain or loss is made with reference to the transferee, and it is then deemed to be that of the transferor. Effectively when the equity instrument is disposed the disposal is not treated as vesting. So when the instrument vests the transferor will be taxable on the gain, which would have been the case had there been no transfer.

The same provision applies where the instrument is acquired by a person other than the taxpayer by virtue of the taxpayer's employment or office of director, without a transfer from the taxpayer. In such a case, the equity instrument is deemed to have been so acquired by the taxpayer and disposed of to the other person, and the taxpayer will be treated as obtaining the gain or sustaining the loss at vesting date.[50]

The provision does not apply however, when an employee disposes of any restricted equity instrument (including by way of forfeiture, lapse or cancellation) to his or her employer, an associated institution or other person by arrangement with the employer in terms of a restriction imposed in relation to that equity instrument for an amount which is less than the market value of that restricted equity instrument.

A punitive measure, aimed at combating these types of schemes, in terms of section 58(2) deems the restricted instruments to be donated at the time that they are deemed to vest for the purposes of section 8C. The value to be placed upon the instruments for donations tax is their fair market value at that time reduced by the amount of any consideration in respect of the donation.

[49] de Koker, A, P. Williams R, C. (2016). *Silke on South African Income Tax, 2.*
[50] Ibid.

4.3. Distribution Implications

Section 8C(1A) provides that a taxpayer must include in his income any receipt or accrual during a year of assessment in respect of a restricted equity instrument if that amount constitutes a return of capital. Section 8C(1A) seeks to include in income any return of capital in respect of a restricted equity instrument. Such a return of capital is considered to constitute an effective vesting of that restricted equity instrument, as some or all of the economic value has been extracted therefrom.

There are also two provisos to section 10(*1*)(*k*) aimed at dividends received in respect of restricted equity instruments. Section 10(1)(*k*)(*dd*) states that dividends will not be exempt from income where the dividend is in respect of a restricted equity instrument as defined in section 8C, unless restricted equity instrument constitutes an equity share, the dividend constitutes an equity instrument as defined in section 8C or, the restricted equity instrument constitutes an interest in a trust and, where that trust holds shares, all of those shares constitute equity shares.

In terms of section 10(1)(*k*)(ii) the dividend exemption does not apply to dividends received in respect of services rendered other than a dividend received in respect of a restricted equity instrument.

SARS have historically disliked dividends in relation to share incentive schemes. They have stated their intention in the past to limit the benefit obtained through disguising income for services rendered as dividends received. In the Explanatory Memorandum On The Taxation Laws Amendment Bill, 2013 National Treasury stated:

> …many share schemes hold pure equity shares where the sole intent of the scheme is to generate dividends for employees as compensation for past or future services rendered to the employer, without the employees ever obtaining ownership of the shares. The dividend yield in these instances effectively operates as disguised salary for employees (that is not deductible by employers) even though these dividends arise from equity shares.

There seems a clear intention of SARS to target corporates share incentive schemes and shut down all the perceived tax benefits arising from the schemes.

4.4. Capital Gains Tax Implications

In order to avoid double taxation under section 8C and the Eighth Schedule, paragraph 11(2)(*j*) of the Eighth Schedule deems the right to acquire equity instruments to be a non-disposal for capital gains tax purposes. Any disposal of an equity instrument contemplated in section 8C will be disregarded for capital gains tax as long as that equity instrument has not yet vested in the hands of the employee at the date of the disposal.

After the equity instrument has vested and the gain or loss has been included or deducted in the employee's income and the employee disposes of the equity instrument a disposal will take place as per paragraph 11(1) of the Eighth Schedule. The capital gain or loss to be included in the income of the taxpayer will be the difference between the proceeds and base cost of the equity instrument. The base cost in terms of paragraph 20(1)(*h*)(i) will be the market value of the equity instrument that was taken into account in determining the amount of that gain or loss upon vesting in terms of section 8C.

In terms of paragraph 12(2)(*a*) if the employee ceases to be a resident the employee is not deemed to have disposed of equity instruments that have not yet vested at the time he ceases to be a resident. Effectively the non-resident employee will include in his or her income the gain or loss resulting from the vesting of the equity instrument per section 8C at the point in time when such equity instrument vests in the employee. This will form part of the non-resident's South African source income.

Anti-avoidance rules in terms of paragraph 38(1) provide that a disposal of an equity instrument by the employee to another person by way of donation or to a connected person in a non-arm's length transaction shall be treated as a disposal. Paragraph 38(1)(a) states that the person who disposed of that asset must be treated as having disposed of that asset for an amount received or accrued equal to the market value of that asset as at the date of that disposal. Paragraph 38(1)(*b*) states he person who acquired that asset must be treated as having acquired that asset at a cost equal to that market value, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(*a*).

Another anti-avoidance measure, paragraph 39(1), effectively ring fences capital losses incurred upon the disposal of an equity instrument to any person who was a connected person in relation to the employee immediately prior to the disposal. If the employee were to make a capital gain on disposal of an asset to the same connected person, the previously disallowed capital loss can be utilised to set off the gain.

In terms of paragraph 39(3)(*a*) a connected person in relation to a natural person does not include a relative of that person other than a parent, child, stepchild, brother, sister, grandchild or grandparent of that person.

The disposal by a trust of any equity instrument contemplated in section 8C to a beneficiary of that trust will not be ring fenced if:

- That right, marketable security or equity instrument is disposed of to that beneficiary by virtue employment with an employer, directorship of a company or services rendered or to be rendered by that beneficiary as an employee to an employer or as a result of the exercise, cession, release, conversion or exchange by that beneficiary of the right, equity instrument contemplated by virtue of employment; and
- That trust is an associated institution as contemplated in paragraph 1 of the Seventh Schedule in relation to that employer or company.

4.5. Fourth Schedule Implications

The Fourth Schedule governs provisional payments of employees' tax otherwise known as Pay-as-You–Earn ('PAYE'). Employees' tax is calculated on 'remuneration' which is a defined term in the Fourth Schedule. Subparagraph (*e*) of the 'remuneration' definition incudes any amount referred to in section 8C which is required to be included in the income of that person.

Paragraph 11A states that for the purposes of the Fourth Schedule, the amount of the gain or amount is deemed to be an amount of remuneration payable to the employee by the person by whom the right was granted or from whom the qualifying equity share or equity instrument was acquired.

Unless the Commissioner has granted authority to the contrary, employees' tax must be deducted or withheld from:

- Any consideration paid or payable by that person to that employee in respect of the cession or release of that right or the disposal of that qualifying equity share; or
- Any cash remuneration paid or payable by that person to that employee after that right has to the knowledge of that person been exercised, ceded or released or that equity instrument has to the knowledge of that person vested or that qualifying equity share has to the knowledge of that person been disposed of.

Where the grantor of the right is a non-resident 'associated institution' in relation to the employer and the associated institution has no representative employer in South Africa or is unable to withhold the employees' tax because the tax due exceeds the cash amount from which it can be deducted or withheld, the associated institution and the employer must jointly ensure (and will be jointly and severally liable) that the tax is properly deducted.[51] This occurs typical when the associate institution is a share incentive trust.

Paragraph 11A(4) provides that a before deducting or withholding employees' tax under that person and that employer must ascertain from the Commissioner, by way of a tax directive, the amount to be so deducted or withheld.

An employee has the duty to inform his employer, under paragraph 11A(5), of any gain or the disposal and the amount of the gain if he has made a gain under a transaction to which the employer is not a party or who has disposed of a qualifying equity share. An employee who without just cause fails to comply is guilty of an offence and liable on conviction to a fine not exceeding R2 000.

4.6. Seventh Schedule Implications

The Seventh Schedule governs the benefits obtained by employees by reason of employment or holding of office. Paragraph (i) of the 'gross income' definition in section 1 of the Act states:

[51] Ibid.

> the cash equivalent, as determined under the provisions of the Seventh Schedule, of the value during the year of assessment of any benefit or advantage granted in respect of employment or to the holder of any office, being a taxable benefit as defined in the said Schedule, and any amount required to be included in the taxpayer's income under section 8A;

Thus any cash equivalent determined under the provisions of the Seventh Schedule will be included in an employee's gross income.

Subparagraph (*b*) of the 'remuneration' definition in paragraph 1 of the Fourth Schedule includes any amount required to be included in such person's gross income under paragraph (i). Therefore any cash equivalent will also be included in determining the amount of employees' tax to deduct and withhold.

Paragraph 2(*a*) of the Seventh Schedule provides that:

> For the purposes of this Schedule and of paragraph (i) of the definition of "gross income" in section 1 of this Act a taxable benefit shall be deemed to have been granted by an employer to his employee in respect of the employee's employment with the employer, if as a benefit or advantage of or by virtue of such employment or as a reward for services rendered or to be rendered by the employee to the employer—
>
> a) any asset consisting of any goods, commodity, financial instrument or property of any nature (other than money) has been acquired by the employee from the employer or any associated institution in relation to the employer or from any person by arrangement with the employer, either for no consideration or for a consideration given by the employee which is less than the value of such asset, as determined under paragraph 5(2): Provided that the provisions of this subparagraph shall not apply in respect of-
>
> …
>
> iv) any equity instrument contemplated in section 8C…

Although paragraph 2(*a*) could be applied to an employee participating in a share incentive scheme, where the employer grants the employee a financial instrument for less than market value, subparagraph (iv) of paragraph 2(*a*) specifically excludes any equity instruments contemplated in section 8C from the scope of paragraph 2(*a*).

There is however, an instance where the provisions of the Seventh Schedule apply to a share incentive scheme structure. Paragraph 2(*f*) of the Seventh Schedule provides for a scenario where debt has been incurred by the employee, whether in favour of the employer or in favour of any other person by arrangement with the employer or any associated institution in relation to the employer, and either no interest is payable by the employee or the interest is payable by the employee at a rate of lower than the official rate of interest.

Paragraph 2(*f*) of the Seventh Schedule would typically apply under a share purchase scheme. Under a share purchase scheme as explained above, a trust is set up for the benefit of the company's employees. The trust will meet the definition of an 'associated institution'. The share trust will purchase or subscribe to shares of the company. Employees are then given the opportunity to buy shares at the market value at the date the offer is made to them. The trust will grant the employees a loan to finance the purchase of the shares. If the loan is granted interest-free or at a below market interest rate a benefit will be deemed to have been granted by the associated institution (the trust) to the employee. The cash equivalent of the benefit will be included in the employee's gross income per paragraph (i) of the gross income definition.

Paragraph 11 of the Seventh Schedule determines the cash equivalent of the benefit to be included in an employee's gross income. Paragraph 11(1) states that the cash equivalent of the value of the taxable benefit shall be the amount interest payable on the loan using the official interest rate less the amount of interest actually incurred by the employee on such loan in respect of the debt in respect of such year. The 'official rate of interest' is defined as the South African Repurchase Rate plus 100 basis points.

Paragraph 11(5) grants the employee some tax relief in that any amount included the employee's taxable income, as a result of being a cash equivalent determined by paragraph 11, will be deductible under section 11(*a*). However, the deduction provided by section 11(*a*) will only be allowed in cases where the loan is utilised by the employee in the production of income. [52] As these loans have been utilised to finance the purchase equity instruments which in most case will earn exempt income in the form of dividends, the deduction will be disallowed.

[52] Jonas, S. (2012). *A Critical Analysis of the Tax Efficiency of Share Incentive Schemes in Relation to Employees in South Africa.* University of Stellenbosch (Masters Degrees (School of Accountancy)), 52.

4.7. A Glance at the Future

In July 2016 the National Treasury released the Draft Tax Law Amendment Bill Proposals for 2016. The document contained a raft of proposals aimed at share incentive schemes. Specifically the target was again on distributions in terms of the employee incentive schemes.

The first proposed amendment was to section 8C(1A). National Treasury reasoned that:

> The policy intent underlying the inclusion, in the income of a holder of a restricted equity instrument, of a return or foreign return of capital was expressed as follows in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010: "Capital distribution will generally trigger ordinary revenue in recognition of this partial cash-out. However, if the capital distribution consists of another restricted equity instrument, the capital distribution will be treated as a non-event." The current exclusion of a return or foreign return of capital does not reflect this policy clearly. A return of capital in the form equity shares that are not restricted will erode the value of the equity shares from which the value of a restricted equity instrument is derived.

The aim of National Treasury is to put a stop to tax avoidance that is currently being achieved through dividend stripping. Dividend stripping occurs if the value derived from the underlying shares is liquidated in full or in part by means of distributions that are effected before the restrictions fall away. The proposal which comes into effect on 1 March 2017 requires a taxpayer to include in his income any receipt or accrual during a year of assessment in respect of a restricted equity instrument if:

- That amount does not constitute a return of capital or a foreign return of capital by way of a distribution of a restricted equity instrument; or
- If is not a dividend or foreign dividend in respect of that restricted equity instrument; or
- If it is not an amount that must be taken into account in determining the gain or loss in terms of this provision in respect of that restricted equity instrument.

There are a number of issues with this amendment however; the amendment simply includes a return of capital in income. No relief is given for any consideration paid for the share on which capital is being returned.

Another issue is that the proposed section 8C(1A) does not exclude capital gains. A trust may dispose of some but not all its shares and the resulting capital gain is vested in the beneficiaries, who hold rights or units in the trust (the units being restricted equity instruments for the purpose of section 8C). For each share disposed of and resulting gain vested in each beneficiary, one Unit is cancelled. This will trigger section 8C(1A) and result in double taxation. The capital gain will taxed in the trust (at an effective rate of 36%) in terms of paragraph 80(2A) of the Eighth Schedule and be included in the income of the taxpayer when the instruments vest (at a marginal rate up to 45%).

The National Treasury did however; take some of the concerns into account in the Final Response Document on Taxation Laws Amendment Bill, 2016 and Tax Administration Laws Amendment Bill, 2016. A technical correction to paragraph 64C will be made in order to extend paragraph 64C to provide that amounts included in the income of a person in terms of section 8C(1A) should be disregarded.

Another proposed amendment was that a dividend in respect of a restricted equity instrument scheme be treated as ordinary revenue. As a result, carve out measures which qualified certain dividends in relation to restricted equity instruments as exempt from normal taxation will fall away. It was further proposed that dividends will only be exempt after the restriction falls away and the equity instrument vests in the employee in terms of section 8C.

This proposal again shows the attitude of National Treasury towards share incentive schemes. No though is given to the intention of such schemes or the economic reality. National Treasury and SARS have a narrow minded view which is that the only rationale to share incentive schemes is to utilise them to disguise remuneration as dividends.

The National Treasury and SARS also seem to have failed to take into account complexities relating to taxing dividends on restricted equity instruments as income. Listed companies utilise regulated intermediaries, such as central securities depository participants (‘CSDPs’), to administer the payment of dividends to the employees. The systems of the CSDPs are set up to withhold dividends withholding tax at 15% from all dividends paid to individuals. Practically it would cause many complications and existing systems will have to be changed as well as a lot data will have to be collected to determine which employees’ shares are restricted and whose are not. Some of the share schemes of listed companies involve thousands of employees and stretch across borders. Another practical issue arises with obtaining tax directives as required by paragraph 11A(4) of the Seventh Schedule when withholding employees’ tax.

The concerns above were taken into account by National Treasury account in the Final Response Document on Taxation Laws Amendment Bill, 2016 and Tax Administration Laws Amendment Bill, 2016. A decision was taken to withdraw the initial proposal to tax dividends on restricted equity instruments as income from the final version of the 2016 Tax Laws Amendment Bill. It can be seen however, from the proposal, previous proposals and narrative from National Treasury and SARS that they are searching for a means to tax dividends in respect of restricted equity instruments as income regardless of commercial reasons.

National Treasury state in the Explanatory Memorandum to Draft Tax Law Amendment Bill 2016:

> Due to the fact that employee share schemes are aimed at encouraging employees to remain in employment and providing an incentive to employees to align their interests with that of the company, any value flowing to an employee (whether through dividends or shares that vest) can be seen as remuneration in the hands of the employee.

This rationale, it is respectfully submitted, is false and reflects a very narrow view. As discussed in chapter 3 there are a multitude of reasons for companies to implement share incentive schemes. Retention of employees is only one of the reasons and it can be argued is not the most significant. Share incentive schemes are utilised to align the goals of shareholders with that of employees. Another objective is empowering previously disadvantaged workers to becoming part-owners of their employers. Broad-Based Black Economic Empowerment (‘BBBEE’) legislation is actively encouraging this while tax legislation is misaligned and effectively punishing the employers and employees trying to achieve these objectives. Nowhere in the Income Tax Act will you find any provision giving tax relief to either the funders or the recipients of employee equity, despite the fact that the state actively encourages, even insists, that businesses grow black ownership.[53]

Some executives have 50% or more of their salary packages linked to share incentives. There is no recognition or acknowledgment of any risk that the executives take. There is ever the possibility that the share incentives could be worthless at some stage. Furthermore, the executive may not be able to extract value from this deferred compensation for many years.[54] A change is certainly required in the mind-set of policy makers is required. The economic realities need to be given more focus when drafting new legislation and not outdated attitudes or revenue collection targets. The focus on taxing share incentives to death is eroding all the potential benefits to share incentives which eventually may lead to employers to stop offering them.

4.8. Conclusion

Tax legislation in relation to share incentive schemes seems to constantly evolve yearly. It appears that here has been a clear intention from the National Treasury and SARS to consistently target share incentive schemes and try and close every perceived loophole and tax benefit. Once there is an attempt to close a loophole, tax advisors find another of obtaining a perceived tax benefit. With the layer upon layer of amendments and insertions no regard is given to potential interactions with other provisions which often results in overly punitive legislation rather than legislation that should contain incentives. This is an on-going cycle which seems to cause ever increasing complexities in share schemes and the tax legislation which governs them.

There appears to be no focus by National Treasury or SARS on the economic reality and benefits to incentivising employee share ownership particularly given the South Africa’s past. Chapter 5 will explain what provisions applicable to employees who set up share schemes. Particular focus will be on what grounds an employer may be able

[53] Foster, D. 2016. *Executive share incentives at the crossroads.*
[54] Ibid.

to claim deductions in relation to the costs of setting up and administering share incentive schemes.

Chapter 5: Deductibility of Share Incentive Scheme Expenses

5.1. Introduction

Employees are taxed on employee benefits received by virtue of employment whether in cash or in kind. This includes being taxed on the vesting of share incentives. The employer will usually be allowed to claim a deduction for employee-related expenditure in terms of the so-called general deduction formula of the Income Tax Act. An employer, in simplistic terms, makes money by providing either goods or services. The money made on those goods or services is taxed. An employer then shifts money to employees through benefits, the employees get taxed thereon, while the employer should be entitled to claim a deduction for the benefits surrendered. This is the general design of income tax systems.

This chapter aims to determine whether an employer is entitled to claim a deduction for the costs incurred in administering a share incentive scheme. A determination of whether the costs incurred to issue shares can be deducted will be made. The deductibility of costs in settling an employee's rights under a phantom share incentive scheme will also be determined. The 'general deduction formula' contained in section 11(*a*) of the Act as well as the principles laid down by in various cases will be examined in making this determination. SARS has also ruled on the deductibility of certain share incentive scheme structures in two specific Binding Private Rulings. These rulings will thus also be discussed.

5.2. Costs to Issue Shares

Section 11(*a*), the so-called general deduction formula, sets out what may be deducted (positive test) and section 23(*g*) sets out what may not be deducted (negative test).[55] The courts have laid down that section 11(*a*) and section 23(*g*) must be read together when one considers whether an amount is capable of deduction.[56]

[55] de Koker, A, P. Williams R, C. (2016). *Silke on South African Income Tax.*
[56] Ibid.

Section 11(*a*) states:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

Section 11(a) can essentially be broken down into the following criteria:

- Person must be carrying on a trade;
- Person have incurred expenditure or losses;
- The expenditure or losses must be actually incurred;
- In the production of income; and
- Not of a capital nature.

In order for an income tax deduction in respect of shares issued to employees the above criteria need to be met.

The nature of the expense is that of a cost associated with the employment or services rendered. In most if not every case the company will be carrying on a trade. The issue of the shares would be in the production of income as staff are remunerated for producing goods or services from which income is produced. Costs associated with the employment of staff are revenue in nature.

The issue therefore, is whether shares issued to staff can be said to be 'expenditure or losses actually incurred'.

5.2.1. 'Actually Incurred'

The view held by Watermeyer AJP in *Port Elizabeth Electric Tramway Company Ltd v CIR*[57] was confirmed in *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste*[58] by Hoexter JA, who stated:

> Dit is 'n bekende grondstelling dat, vir doeleindes van art 11(a) van Wet 58 van 1962, onkoste werklik aangegaan is in daardie belastingjaar waarin aanspreeklikheid daarvoor regtens ontstaan, en nie (vir geval beta ling daarvan later sou plaasvind) in die belastingjaar waarin daadwerklike vereffening van die skuld geslded het nie ... Aileen onkoste ten opsigte waarvan die belastingbetaler 'n

[57] *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13 at 15.
[58] *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A).

> volstrekte en onvoorwaardelike aanspreeklikheid op die hals gehaal het, mag in die betrokke belastingjaar afgetrek word.

Hoexter JA is essentially stating that expenditure 'actually incurred' arises in the tax year which a taxpayer is liable to settle the expenditure and the expenditure arises when the taxpayer has an absolute and unconditional liability to settle the expenditure.

Further confirming the position above Corbett JA delivering the judgment of the majority of the Appellate Division in *Edgars Stores Ltd v CIR:*[59]

> Thus it is clear that only expenditure (otherwise qualifying for a deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s. 11 (a) from income returned for that year.

Under a share incentive scheme it is likely that the trust deed or another legal document would contain an unconditional obligation for the company to issues shares to the trust or the employees in terms of a share incentive plane. The issue of shares can therefore, meet the criteria of 'actually incurred' under section 11(*a*).

5.2.2. 'Expenditure or losses'

The word 'loss' or 'expenditure' is not defined in the Act. In *Joffe & Co (Pty) Ltd v CIR*[60]the court considered that the word 'loss' had several meanings. Watermeyer CJ, who delivered the judgment of the Appellate Division of the Supreme Court, stated that:

> in relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money.

In *Port Elizabeth Electric Tramway Co Ltd v CIR,*[61] the court considered that in the context the word appeared 'to mean losses of floating capital employed in the trade which produces the income'. Watermeyer AJP further stated:

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[59] E*dgars Stores Ltd v CIR*1988 (3) SA 876 (A), 50 SATC 81 at 90.
[60] *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354 at 360.
[61] *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13 at 15.

> But expenses actually incurred cannot mean actually paid. So long as the liability to pay them actually has been incurred they may be deductible.

The case of *C: SARS v Labat Africa Ltd*[62] is an important case as the crux of the case was whether issuing shares constitutes expenditure under the general deduction formula.

The background to the case is as follows: the taxpayer, under its former name of Acrem Holdings Ltd, purchased "the entire business operations" of Labat-Anderson (South Africa) (Pty) Ltd in terms of a written agreement dated 15 February 1999. Its effective date was 1 June 1999. The business operations of Labat-Anderson were defined to include all its tangible and intangible assets including, more particularly, the trademark. In terms of clause 6 of the agreement, under the heading sale, the taxpayer purchased the business for a consideration of R120 million, discharged by the issue to Labat-Anderson of 133 333 333 Acrem shares at an issue price of 90 cents per share.

The taxpayer sought to claim a deduction from its taxable income during the 2000 year of assessment for the acquisition of the trade mark in terms of section 11(*gA*)(iii) of the Act, which read as follows at the time:

> For the purposes of determining the taxable income derived by any person from carrying on any trade in the Republic, there shall be allowed as deductions from the income of such person so derived an allowance of any expenditure (other than expenditure which has qualified in whole or part for deduction or allowance under any of the other provisions of his section or the corresponding provisions of any previous Income Tax Act) actually incurred by the taxpayer in acquiring by assignment from any other person any such patent, design, trade mark or copyright or in acquiring any other property of a similar nature or any knowledge essential to the use of such patent, design, trade mark, copyright or other property or the right to have such knowledge imparted such invention, patent, design, trademark, copyright, other property or knowledge, as the case may be, is used by the taxpayer in the production of his income.

The company claimed the deduction under section 11(*gA*)(iii), the appellant, the Commissioner of SARS, disallowed the deduction on the grounds that the taxpayer did not expend any monies or assets in discharging its obligation, and accordingly did not actually incur expenditure as required by section 11(*gA*).

[62] *C: SARS v Labat Africa Ltd* (2012) 74 SATC 1 (SCA).

The Commissioner's argument was based on a judgment in ITC 1783,[63] 2004 by the Tax Court, where it was held that:

> "[a]n allotment or issuing of shares by a company does not in any way reduce the assets of the company…" and it was accordingly held that the issue of a company's own shares does not constitute expenditure incurred by that company.

The taxpayer appealed to the Income Tax Special Court under ITC 1801 in which the Tax Court upheld the taxpayer's appeal.[64]

The Income Tax Special Court gave the following reasons for its judgement:
Firstly, the expression 'expenditure actually incurred' meant that the taxpayer must have incurred an unconditional legal obligation in respect of the amount concerned. It is not required that the obligation be discharged. Once the obligation has been incurred, the expenditure becomes deductible. This decision relied on *Edgars Stores Ltd v Commissioner of Inland Revenue.*[65]

Secondly, the Tax Court also referred to some English judgments that dealt with the effect of a transaction in terms of which a company acquires an asset in consideration of the issuance of fully paid shares.

The first judgment relied on was *Osborne v Steel Barrel Co Ltd,*[66] the court, in this case, decided that the issue of shares for the acquisition of assets amounted to 'consideration' given by the company. [67]

The other cases were *Craddock v Zevo Financing Co ltd*[68] and *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd*.[69] In the Craddock case, the court proposed that a company can issue its own shares 'as consideration for acquisition of property' and secondly, that the value of consideration given in the form of fully paid shares allotted by a company is not the value of the shares allotted but is, in the case

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[63] *ITC 1783* 66 SATC 373.
[64] Gwindingwi, S.(2013). *Was the Supreme Court of Appeal correct in CSARS v Labat?* Cape Town: University of Cape Town (PG. Dip (Tax Law): Research Paper), 7.
[65] Ibid.
[66] *Osborne v Steel Barrel Co Ltd* 1942 1 A11 ER 634 (CA).
[67] Gwindingwi, S.(2013). *Was the Supreme Court of Appeal correct in CSARS v Labat?* Cape Town: University of Cape Town (PG. Dip (Tax Law): Research Paper), 8.
[68] *Craddock v Zevo Financing Co Ltd* 1944 1 A11 ER 566 (CA).
[69] *Stanton (Inspector of Taxes) v Drayton Commercial Investments Co* Limited 1982 1 A11 ER 121 (CA)

of an honest and straight forward transaction, the price on which the parties involved in the transaction agreed on.[70] In the Stanton case it was held that the agreed issue price of the company's own shares constituted consideration for assets acquired by the company and the company was entitled to a deduction of such amount.

The Commissioner appealed the decision of the Income Tax Special Court to the High Court which dismissed the appeal. The judgment confirmed that the taxpayer was only required to incur an unconditional legal obligation to meet the deductibility requirement, which was not dependent upon the making of payment. It was further held that if the agreement for the acquisition of the trade mark had instead been that the seller would purchase an agreed number of the unissued shares of the purchaser at an agreed price and that such proceeds of issue would be used to pay for the trade mark, the transaction would undoubtedly constitute expenditure.

Following the High Court's dismissal of the appeal, the Commissioner appealed to the Supreme Court of Appeal ('SCA').

The SCA held that the decision by the lower courts on the expression 'actually incurred' was indeed correct. The lower courts had correct determined from the principles of *Edgars Stores Ltd v Commissioner of Inland Revenue,*[71] that the taxpayer must have incurred an unconditional legal obligation in respect of the amount concerned and that it is not required that the obligation be discharged. Once the obligation has been incurred, the expenditure becomes deductible.

The SCA further held that although the lower courts had correctly determined the applicable principles relating the term 'actually incurred', they did not deal with the meaning of 'expenditure'. The question the lower courts should have posed was whether the issuing of shares by a company amounts to 'expenditure' and not whether the undertaking to issue shares amounts to an obligation, which it obviously does.

[70] Gwindingwi, S.(2013). *Was the Supreme Court of Appeal correct in CSARS v Labat?* Cape Town: University of Cape Town (PG. Dip (Tax Law): Research Paper), 8.
[71] E*dgars Stores Ltd v CIR*1988 (3) SA 876 (A), 50 SATC 81 at 90.

Harms AP, in paragraph 8, stated:

> ”the terms”, “obligation” or “liability” and “expenditure” are not synonymous as it is apparent from the judgment of Caltex Oil (SA) Limited v Secretary for Inland Revenue by Botha JA in the statement: “any expenditure actually incurred” means “all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during the year or not”.

Harms AP went further by contending, the liability or obligation must be discharged by means of expenditure and that timing is not the question.

The SCA agreed that the issue of a company’s own shares for the acquisition of assets amounted to ‘consideration’. It was held, however, that this fact was never a point of contention. The statutory provision required the taxpayer to actually incur ‘expenditure’ and no reference was made to ‘consideration’. The English judgments were accordingly ruled to be irrelevant to the present case.

Harms AP went further using Goldblatt J’s judgment in ITC 1783[72]which said,

> an allotment or issue of shares does not in any way reduce the assets of the company although it might reduce the value of the shares held by shareholders, therefore it cannot qualify as an expenditure.

The appeal was upheld with costs.

Even though the *Labat* judgment dealt with an old section, section 11(*gA*)(iii), the courts will likely rely on the decision in determine the meaning of ‘expenditure’ contained in the general deduction formula. In effect a deduction for employer incurring expenditure in relation to issuing shares will be disallowed.

The debate around the judgement in *Labat* is now largely academic as the decision has been overtaken by a number of statutory provisions which prescribe the treatment for the issue of shares or debt in different circumstances.[73]

The statutory provisions which prescribe the treatment for the issue of shares however, do not cater for the issuing of shares under a share incentive scheme. As such where a company issues shares to an employee for services rendered under,

[72] *ITC 1783* 66 SATC 373.
[73] de Koker, A, P. Williams R, C. (2016). *Silke on South African Income Tax.*

under a section 8C share incentive scheme, no deduction is available based on the decision of the court in the *Labat* case.

The act does allow a deduction, in terms of section 11(lA) where shares are issued in respect of qualifying equity shares issued pursuant to a so-called 'broad-based employee share plan,' as envisaged in section 8B of the act. It is submitted, that due to the onerous requirements to qualify as a broad-based employee share plan under section 8B, the scheme is not widely used and therefore is not discussed further.

5.3. Costs in relation to phantom share schemes.

As phantom share scheme is different to traditional share incentive schemes as no actual physical shares are issued to employees, it follows that the tax treatment with regards to these types of schemes may be different.

5.3.1. Recap on structure

Units are allocated to employees either by the company or through the use of a share trust. As these units are not actual shares it does not entitle employees with any rights in relation to share ownership and thus none of the company's actual shares are issued. The scheme amounts to a contract between the company or share trust and each employee whereby the employee receives what is, effectively, a bonus.

The units in the phantom share scheme often have two rights attached to it, namely the right to receive dividends and the right to participate in the appreciation or growth of the company (share appreciation rights).

Upon the expiry of certain time periods, the holder of a unit is paid an amount equal to the market value of an actual share or the growth in the market value since the allocation date of the unit. The units are also often called share appreciation rights.

5.3.2. Determination of whether expenses are deductible

In order to determine whether the employee expenses are deductible in terms of a phantom share scheme the general deduction formula contained in section 11(a).

Section 11(a) can essentially be broken down into the following criteria:

- Person must be carrying on a trade;

- Person has incurred expenditure or losses;
- The expenditure or losses must be actually incurred;
- In the production of income; and
- Not of a capital nature.

In order for an income tax deduction in respect of shares issued to employees the above criteria need to be met.

The nature of the expense is that of a cost associated with the employment or services rendered. In most if not every case the company will be carrying on a trade. The issue of the shares would be in the production of income as staff are remunerated for producing goods or services from which income is produced. Costs associated with the employment of staff are revenue in nature.

The issue therefore, is whether shares issued to staff can be said to be 'expenditure or losses actually incurred'.

It is submitted that the company will have 'unconditional legal obligation'[74] to incur costs to settle the share appreciation rights and to pay the so called dividend. It is likely that the trust deed or another legal document would contain an unconditional obligation for the company to settle the share appreciation rights of the employees in terms of a phantom share scheme. The costs therefore, meet the criteria of 'actually incurred' under section 11(*a*).

In *C: SARS v Labat Africa Ltd*[75] the SCA stated the ordinary meaning of 'expense' refers to the action of spending funds, disbursement or consumption, and hence the amount of money spent.[76]

It is submitted that when a company settles share appreciation rights the company will have to spend funds and thus the costs therefore, meet the criteria of 'expenses' under section 11(*a*).

[74] E*dgars Stores Ltd v CIR*1988 (3) SA 876 (A), 50 SATC 81 at 90.
[75] *C: SARS v Labat Africa Ltd* (2012) 74 SATC 1 (SCA).
[76] de Koker, A, P. Williams R, C. (2016). *Silke on South African Income Tax.*

Section 23m(1)(*f*) states that any expenses incurred in respect of any amounts received or accrued which do not constitute income as will not be deductible. As discussed above a unit in a phantom share scheme will meet the definition of an 'equity instrument'. As the interest in a phantom share scheme does not fall within the three provisos contained in section 10(1)(*k*)(*dd*), the so called 'dividends' linked to the share appreciation rights will be included in the income of the employee. The 'dividends' which are paid by the employer will also thus qualify for a deduction.

It is submitted that the costs related to administering a phantom share scheme, including the gain and dividends paid on share appreciation rights, will be deductible in terms of section 11(*a*). One must bear in mind that the discussion above is however, very simplistic. The specific facts and circumstances when determining if a deduction can be claimed will need to be examined in depth.

5.4. Binding Private Rulings

Binding Private Rulings ('BPRs') are issued in favour of an applicant (or applicants) and cannot be applied in general by other taxpayers. They determine how SARS interpret and apply the relevant tax law's provisions in relation to a proposed transaction. BPRs are however, useful in determining how SARS is likely to interpret provisions relating to a similar transaction.

BPR 50 dealt with deductibility for tax purposes of cash grants made by an employer to employee share-incentive scheme trusts to enable the trusts to acquire shares in fulfilment of the employer's share-incentive scheme obligations.[77]

The structure of the transactions was as follows: the applicant had share incentive schemes for different categories of employees, management and directors. The applicant intended to make cash grants to the trust in order for the trust to purchase shares to allocate to beneficiaries. The ruling dealt with two of the applicant's schemes, one for low income employees and the other employees.

The structure of the share trust for low income employees was as follows:

- The applicant will grant a cash award to the trust;

[77] BPR 50.

- The trust will use the cash to acquire the applicant's shares through either a new issue of shares or purchasing shares on the open market;
- The trust will immediately vest the shares in the qualifying employees, subject to a resolutive condition that the employees will remain in the employ of the applicant until death, retirement, retrenchment or the sale of a division;
- At the discretion of the trustees, the resolutive condition may be waived, but only after a period of at least 10 years from the date the shares were granted;
- Dividends on vested shares will accrue to the employees and will be paid by the trust to the employees when dividends are declared and paid; and
- In addition to the entitlement to receive dividends, the employees will have full voting rights.

Structure the other share trusts is as follows:

- The applicant will grant a cash award to the trust;
- The trust will use the cash to acquire the applicant's shares through either a new issue of shares or purchasing shares on the open market;
- Each trust will grant options to qualifying employees to acquire the applicant's shares. These share option grants will occur on specified dates;
- The vesting and exercise of the share options will be staggered and deferred to future specified dates;
- Vesting will occur in tranches after from 3 to 7 years;
- The strike price will be set at the weighted average price of the applicant's shares for the 30 trading days prior to the date of grant of the share options;
- Within 90 days of vesting, employees are obliged to either exercise their share options by acquiring the shares at the strike price or to forfeit their share options; and
- Dividends accruing on the shares held by each trust may, at the discretion of the trustees, be distributed to the Applicant, as an income beneficiary of the trust.

Essentially the low income earning employee scheme is a share purchase scheme and the other schemes are share option schemes.

SARS ruled that the cash grants to be made by the applicant to the various share trusts will be deductible under section 11(*a*) and that the provisions of section 23H will apply to the expenditure to be incurred in respect of the grants to be made.

A more recent ruling was made in BPR 161. BPR 161 dealt with the income tax and employees' tax consequences for an employer and a trust through which an employee share scheme will be implemented.[78]

The purpose of the employee share scheme under the application was to allow qualifying employees to participate in the benefits attributable to the shares of the employer company's JSE listed holding company ('HoldCo').

A trust was used as a special purpose vehicle for carrying on the employee share scheme and qualifying employees were allocated notional units (trust units) which will determine their participation in the dividends and net capital proceeds attributable to the shares. Each trust unit will restrict the employee to whom it is allocated from disposing of the shares for a specified 'lock-in' period.[79] Once shares were acquired the trust will issue trust units and will be equal to the number of shares acquired.

The rights attached to the trust units which are allocated to a beneficiary will entitle the beneficiary to:

- an immediate vested right to the dividends received by the trust;
- an immediate vested right to the net capital proceeds realised by the trust upon the disposal of the shares; and
- a vested right to the shares held by the trust when the trustees exercise their discretion to vest the shares in the beneficiaries.

After the lock-in period the units will be considered matured and the beneficiary shall be required to notify the trustees if wither the trustees must dispose of the related shares and distribute the net capital proceeds to the beneficiary or vest the shares in and transfer them to the beneficiary.

[78] BPR 161.
[79] Lewis, A. (2014) *Employee share ownership plan ruling.*

SARS ruled that the contributions by the employer company to the trust for purposes of this particular share incentive scheme will be deductible under section 11(*a*), read with section 23(*g*) of the Act. The ruling is similar to the ruling that was issued in BPR 50 above.

It should be noted that binding private and binding class rulings are only binding between SARS and the applicants to the ruling. Other persons may not cite binding private and binding class rulings in any proceedings, including court proceedings, against SARS.

Particular attention should be given to the facts and circumstances around the specific transaction. Depending on the facts and circumstances a different interpretation may be made. An employer should therefore apply to SARS for their own advanced tax rulings in order to obtain for certainty.

It is however, encouraging to note that from the above two rulings in BPR 50 and BPR 161 there seems to be consistency in the interpretation of the provisions. This seems to indicate that employers can deduct certain costs in relation to share incentive schemes depending on the structure.

5.5. Conclusion

Employers set up share schemes for multiple reasons which include, aligning the interest of shareholders and employees, retaining and motivating employees and in order to improve employee productivity. Employers will thus incur expenditure setting up and administering these schemes which can be very costly. Employees are taxed heavily on the benefits received by virtue of these share incentives. The employer will thus seek to claim a deduction for employee-related expenditure in terms of the so-called general deduction formula of the Income Tax Act.

The provisions of the general deduction formula, as well as the principles contained in various case law was utilised in deterring that expenditure incurred for the issuing of shares is not deductible. This is in line with the ruling in the *Labat*[80] case.

[80] Lewis, A. (2014) *Employee share ownership plan ruling.*

It was further determined that expenditure incurred in the administering of a phantom share incentive scheme may be deductible in terms of the provisions of section 11(*a*) read with section 23(*g*).

Two notable rulings made in BPR 50 and BPR 161 was discussed. It was determined that the rulings were favourable for certain share incentive scheme structures. It is however worth mentioning that the particular facts and circumstances would need to be examined in depth. An employer will not be able to cite binding private and binding class rulings in any proceedings, including court proceedings, against SARS.

Chapter 6: A Critical Comparison of the Taxation of Employee Share Incentives Schemes in the UK and South African

6.1. Introduction

Employee share incentive schemes are widely utilised all over the world. Various jurisdictions have differing tax treatments including offering incentives to employees who are participants to the schemes. One such jurisdiction is the UK. In the UK various types of share scheme structures are implemented. The UK unlike South Africa however, has five approved schemes which offer tax incentives to employees. These approved schemes are called; Share Incentive Plans ('SIPs'), Save As You Earn Plans ('SAYE'), Company Share Option Plans, Enterprise Management Incentives ('EMIs') and Employee Shareholder Shares. If the plans do not fall into the above approved schemes they are taxed similarly to how share incentives are taxed under section 8C. In this chapter the taxation of so-called 'unapproved plans' will be discussed and contrasted to the tax treatment in terms of section 8C. The five different types of approved plans will also be discussed.

6.2. Taxation of Unapproved Schemes in the UK

The Income Tax (Earnings and Pensions) Act 2003 ('ITEPA 2003') is the main piece of legislation governing taxation in the UK.

Unapproved schemes fall in three categories namely an Unapproved Share Option Plan, Phantom Share Option Plan and Performance Share Plans ('PSPs').

6.2.1. Unapproved Share Option Plans

An unapproved option is an option which does not have tax favoured status under an approved executive option plan. An unapproved option plan is essentially structured the same was as share option scheme mentioned in chapter 2 above.

Tax Treatment

There is no tax charge on the grant date of an unapproved option. On exercise of the option however, income tax will be charged on the difference between the market value of the shares at the date of exercise of the option and the option exercise price. This is similar to the treatment in South Africa under section 8C.

There will be withholding obligations for the employing company if at exercise the shares under the option are in a listed company, a company which is controlled by a privately held company, or if there are arrangements for that company to be sold or for its income to be listed. The shares are regarded as ‘readily convertible assets’ (‘RCAs’). If the shares are however, in a privately owned company and there are no arrangements for it to be sold, then there is no withholding obligation. The withholding obligations are similar to the obligations under the Fourth Schedule of the Act. There are however, subtle differences between a private and public companies in the UK, which are not significant.

There will also be national insurance contributions ("NICs") liability for the employee and the employer on the amount of the option gain if the shares are RCAs. The UK has a National Insurance scheme which employees contribute to on a monthly basis. The amount withheld from an employee’s salary is a percentage of income depending how much the employee earns.

On the sale of shares there will be a charge to capital gains tax on the difference between the price received for the sale of the shares and the aggregate of the market value on the date of exercise of the option. This again is similar to the capital gains tax provisions contained in the Eighth Schedule of the Act.

It is submitted that the treatment above is identical to the treatment under South African tax law.

6.2.2. Phantom Share Option Plans

Phantom share option plans are identically structured to the phantom share incentive schemes mentioned in chapter 2. A phantom share option plan is effectively a cash bonus plan under which the amount of the bonus is determined by reference to the increase in value of the shares subject to the option. No shares are actually issued or transferred to the option-holder on the exercise of the phantom share option.

The scheme works similarly to a share option scheme. The employee is granted an option over a number of shares at an option price. Then when the employee exercises the option the employee simply gets a cash bonus which, subject to the rules of the plan, is equivalent to the difference between the market value of the shares at exercise and the option price.

The tax treatment is simple as the employee will be taxed on the bonus awarded at the employee's marginal rate.

It is submitted that the treatment will be similar under section 8C. This is because when an employee's option vests under a phantom share scheme the gain will include in the employees income. The gain will be calculated by determining the market value on vesting date and deducting the consideration paid on grant date.

6.2.3. Performance Share Plans

PSPs (sometimes referred to as Long-Term Incentive Plans) involve the award of free shares to participants conditional to the achievement of specified performance targets and continuous employment over a vesting period.[81]

The plan is usually structured in one of two ways:

- The employer grants the employee a conditional right to receive the shares in the future at no cost to the employee. Once the conditions have been achieved the shares are delivered to employee; or
- Participants are granted an option which becomes exercisable one the vesting period ends and the performance conditions are met. This allows the participant to choose when he or she would like to exercise that option. An employee can thus defer the tax event provided that the employee exercises the option before it expires.

The employee will incur an income tax charge on the market value of the share at delivery or the date the employee exercise their option. A similar tax scenario would arise in terms section 8C.

On the sale of shares there will be a charge to capital gains tax on the difference between the price received for the sale of the shares and the aggregate of the market

[81] Deloitte. (2014) *Share Success. Your guide to employee share pans in the UK and beyond.*

value on the date of exercise of the option or date of delivery. This again is similar to the capital gains tax provisions contained in the Eighth Schedule of the Act.

6.2.4. Conclusion

The similarity between the taxation of unapproved share plans in the UK is undoubtedly similar to the taxation of share incentive schemes in South Africa under section 8C. This is evidenced by the three examples above. This is unfortunately where the similarities end as it is submitted there are very limited tax incentives available to employees in South Africa.

6.3. Taxation of Approved Schemes in the UK

6.3.1. Share Incentive Plans

SIPs are plans where shares can be delivered to an employee in four different ways:

- Free shares;
- Partnership shares;
- Matching shares; or
- Dividend shares.

Free shares are basically where an employer can give an employee up to £3,600 of free shares in any tax year. Partnership shares are where an employee can buy shares out of his or her salary before tax deductions. This is limited to the lower of, £1,800 or 10% of your income for the tax year. Matching shares is where an employer can give an employee up to two free matching shares for each partnership share you buy. Dividend shares is where an employee may be able to buy more shares with the dividends he or she receives from free, partnership or matching shares.

The following tax implications apply in relation to SIPs:

- If the shares are kept in the plan for five years no Income Tax or National Insurance on their value will be payable;
- No capital gains tax will be payable on shares sold if they are kept in the plan until they are sold; and
- No Income Tax will be payable if the dividend shares are kept for at least 3 years.

It follows that Income Tax and National Insurance will be payable on any shares taken out of a SIP early (less than five years).It also follows that if the shares are taken out of the plan, kept and then sold later on, capital gains tax will be payable if their value has increased.

6.3.2. Save As You Earn

This is a savings-related share scheme where an employee can buy shares with their savings for a fixed price.[82]

An option is attached to a savings contract whereby an employee agrees to monthly deductions up to £500 a month. The exercise price of the option may be discounted by up to 20% of the market value on grant date. The options may be exercised at the end of a three or five year term.[83]

A tax free bonus may also be paid at the end of the savings term. This is however, only available to five year plans. The bonus effectively amounts to interest earned. The savings are used to pay the exercise price of the option at the end of the period. No Income Tax or National Insurance is payable on the difference between the exercise price and the market value when the options are exercised.

Capital gains tax will be payable if the shares are sold. There is however an exemption, if an employee places the shares into an Individual Savings Account ('ISA') or pension as soon as the shares are bought no capital gains tax will be payable. An ISA is similar to a Tax Free Savings Account in South Africa.

6.3.3. Company Share Option Plan

This gives an employee the option to buy up to £30,000 worth of shares at a fixed price. The exercise price cannot be less than the market value at grant date.

No Income Tax or National Insurance contributions on the difference between what is paid for the shares and the market value when the options are exercised. Capital gains tax will however be payable when the shares are sold. Capital gains tax will be

[82] Ibid.
[83] Ibid.

calculated on the difference between the selling price and the market value on exercise date.

6.3.4. Enterprise Management Incentives

The Enterprise Management Incentive (EMIs) is a share based tax incentive targeted at independent trading companies with a gross asset base of £30 million or less.

The EMI is an option or right to purchase a stated number of shares in a company. The market value of the shares at the time of the grant must not exceed £250,000 for each employee.

No Income Tax or National Insurance is payable on the difference between the exercise price and the market value when the options are exercised. Capital gains tax will however be payable when the shares are sold. Capital gains tax will be calculated on the difference between the selling price and the market value on exercise date.

There are certain activities that are excluded from participating in an EMI scheme. These include:

- banking;
- farming;
- property development;
- provision of legal services; and
- ship building.

6.3.5. Shareholder Shares

To qualify as employee shareholder, an employee must own shares in his or her employer's company that were worth at least £2,000 when the employee received them.

An employee cannot be connected with someone (such as a business partner, spouse or family member) who has 25% or more voting rights in the company. The employee also cannot hold 25% or more voting rights in the company.

No Income Tax or National Insurance is payable on the first £2,000 worth of employee shareholder shares received before 1 December 2016. The employee's liability to pay capital gains tax when he or she sells is or her shares depends on when the employee shareholder agreement was signed. If it was signed before 17 March 2016, capital gains tax is payable on shares that were worth over £50,000 when they were received. If it was signed after 17 March 2016, capital gains tax is payable on gains over £100,000 that are made over the employee's lifetime.

6.4. Section 8B

Section 8B of the Act was introduced to lighten the tax burden when shares are transferred to employees on a broad basis. Section 8B It provides for the inclusion in income of a gain made by a person on the disposal of a qualifying equity share or a right or interest in a qualifying equity share, if it is disposed of by the person concerned within five years from their date of grant.

Conversely where the shares are disposed of after five years from their date of grant, the gain will be treated as a capital gain and taxed under the Eighth Schedule to the Act.

The granting of qualifying equity shares under a broad-based employee share plan does not constitute a taxable fringe benefit. The grant will also be exempt from donations tax in terms of section 56(1)(*k*). The grant will also be and is exempt from normal tax under section 10(1)(*nC*). If the employer grants interest-free loans to enable the employee to acquire the shares the loans are also excluded as a taxable benefit.

A 'broad-based employee share plan' is a defined term in the Act.

- The employer company must offer equity shares in itself or in a company that is an associated institution;
- The employees may not participate in any other equity scheme of the employer or of a company that is an associated institution;
- The offer must be made to at least 80% of all employees (excluding those who participate in another equity scheme of the employer or of a company that is

an associated institution) employed on a permanent basis, who have continuously been so employed on a full-time basis for at least one year.

- No onerous restrictions must be imposed in respect of the disposal of the shares other than;
  - a restriction imposed by legislation;
  - a right of any person to acquire those equity shares from the employee or former employee who acquired the equity shares where the employee or former employee is or was guilty of misconduct or poor performance, at the lower of market value on the date of grant or the market value on the date of acquisition, or, in any other case, at market value on the date of acquisition by that person; and
  - a restriction upon the disposal of the shares by the employee or former employee who acquired the shares for a period not exceeding five years from the date of the grant.

Section 8B(3) defines a 'qualifying share' as share which is acquired by a person in terms of a broad-based employee share plan and the market value of all equity shares so acquired by that person does not in aggregate exceed R50 000 in value in the current year and the four immediately preceding years of assessment

6.5. Conclusion

Share incentive schemes are popular and utilised in many jurisdictions throughout the world. There are a multitude of different types of schemes that are utilised in different jurisdictions. Different tax authorities have differing views on how to tax share incentive schemes. There are many countries who offer tax incentives to employers and employees to implement certain types of share incentive schemes. These tax authorities recognise that share incentives are important in aligning shareholders and employee interest, retaining and attracting talent and increasing productivity.

One such jurisdiction which offers tax incentives is the UK. The UK has two broad categories of schemes, unapproved share schemes and approved share schemes. Unapproved share schemes are taxed in very similar manner to South Africa. South Africa offers very limited tax incentives in terms of section 8B. It is submitted that section 8B is too restrictive and onerous and does not adequate incentives in comparison with the UK approved share plans.

The UK approved plans are tax efficient and are structured in a way that is very attractive for employees. The UK even offers participants in SAYE plans and SIPs the option to transfer up to £15,240 of employee shares into a stocks and shares ISA account. No capital gains tax will then be payable on the gain in these shares transferred to the ISA account. This benefit incentivises employees and encourages a savings culture. This type of incentive would be very attractive in a South African context as it could help encourage a savings culture in a country which has one of the worst savings rates in the world according to the Association for Savings and Investment South Africa. It is unfortunate that SARS and National Treasury do not recognises these benefits.

Chapter 7: Conclusions and Recommendations

7.1. Summarising Remarks

This study sought to analyse and evaluate whether current tax legislation is discouraging employee share ownership. This was achieved through an execution of a literature review that considered past and present legislation, court judgments and various other literature sources relating to share incentive schemes.

In chapter 2 the structures of share incentives schemes was discussed and examined. It was found that the four most common types of share incentive schemes are share option schemes, share purchase schemes, deferred implantation schemes and phantom share schemes. Key terms and principles were discusses in order to assist in understanding how share incentive schemes function.

In chapter 3 the motivation of employers offering and employees participating in such share incentive schemes was analysed to determine why share incentive schemes are still utilised as part of employees' remunerator packages. It was found that companies implement share incentive schemes for a variety of reasons. These reasons include aligning the interest of shareholders and the interests of management and employees, attracting and retaining key employees, enhancing productivity and motivating employees.

In chapter 4 a detailed analysis was conducted into the relevant tax legislation, in order to determine the tax implications on the employee participants in the schemes. This analysis included discussing the tax treatment of share incentives under section 8C, the distribution implications, capital gains tax implications, employer withholding obligations and fringe benefit implications. An analysis was also conducted into the potential impact new proposal made by National Treasury and SARS in the Draft Tax Laws Amendment Bill. Through the analysis it was determined that Treasury and SARS view share incentive schemes with suspicion. They consider these schemes as salary conversion plans designed avoid tax and are determined in ending every perceived tax benefit implicit in share incentive scheme structures. This has resulted in overly complex tax legislation with is far too punitive.

In chapter 5 an analysis into the deductibility of the expenses relating to share incentive schemes was conducted with reference to the relevant tax legislation a principles laid down in case law as well as certain rulings made by SARS. It was found that the expenses to issue shares are not deductible in terms of section 11(*a*). Expenses however, could be deductible depending on how the scheme is structured.

In chapter 6 the taxation of share incentives in the UK was then analysed and contrasted to the tax treatment in South Africa to determine what the way forward in South Africa should be. It was found that unapproved share schemes in the UK are taxed in very similar manner to South Africa. It was further found that the UK approved plans offer large tax incentives, are very tax efficient and are structured in a way that is very attractive for employees.

7.2. Recommendations

It is submitted that the current tax regime governing share incentives is overly punitive. Rather than offering incentives to employers and employees SARS has taken the view that share incentives only exist to facilitate salary conversion schemes and in fact share incentives are effectively a salary and nothing else.

Share incentive schemes are utilised to align the goals of shareholders with that of employees. Another objective is empowering previously disadvantaged workers to becoming part-owners of their employers. Broad-Based Black Economic Empowerment (‘BBBEE’) legislation is actively encouraging this while tax legislation is misaligned and effectively punishing the employers and employees trying to achieve these objectives.

SARS need to rethink the tax legislation and seek to encourage the use of share incentive schemes rather than punish there use. As demonstrated in chapter 6, SARS could utilise a similar model to the UK which could encourage South African employees to save and improve employees’ and their families’ lives. The model could also be utilised in conjunction with BBBEE legislation and encourage employers to implement these schemes with attractive tax allowances.

7.3. Limitations of the Research and Areas for Future Research

Share schemes are very complex and a myriad of structures exist throughout South Africa and the world. This aim of the research was to examine the principles of taxation of the share schemes on a general basis. Detailed complexities arising from specific scenarios such as cross-border share schemes were not considered. The research also did not take into account any other tax implications such as Securities Transfer Tax. There are also complex requirements for share schemes in terms of the Johannesburg Stock Exchange ('JSE') which were not discussed. It should also be noted that this dissertation did not provide an analysis of share incentive schemes in any other jurisdiction besides the UK.

Based on this report a comprehensive comparative study should performed to investigate the taxation of share incentive schemes in some of the more developed counties such as New Zealand, United States of America, Australia and various countries within the European Union. An analysis into the impact of the fiscal, socio-economic and political effects that tax incentives have on employees who participate in these schemes should be performed. This could assist South Africa in overhauling and redesigning the taxation of share schemes and introduce tax incentives that could benefit employees and that assist in empowering workers and encourage a savings mentality.

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