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2014-08-22
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'Is Treasury broadening the divide between shareholders and employees – an analysis of the role taxation plays in share incentive plans'

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

Johannesburg, 2013

Abstract

It is commonly understood that it is the people within the organisation that hugely affect the efficiency and work environment, which ultimately brings about greater profitability and value. With this in mind, corporate entities continue to ensure that they are attracting and retaining high performing individuals to their organisations with the view of generating greater value for shareholders. The question then arises as to how to attract key individuals to an organisation and keep those individuals. The use of share incentive plans is an established tool implemented by corporates which incentivises employees to remain at an organisation for an extended term while at the same time, attempts to align the interest of the employee with that of the shareholders. Share incentive plans provide one such solution of achieving both these objectives, but how practical is it to implement such an incentive plan in light of the constantly changing tax landscape. Against this commercial driver to attract and retain employees is the apparent mistrust by Treasury and SARS of the use of share plans to incentive employees which is considered by Treasury and SARS as a salary conversion plan with the objective of obtaining a tax advantage.

This paper will consider the practical issues faced by corporates trying to implement share incentive schemes to secure the employee's income earning structure for a prolonged period and aligning the interests of the employee with the shareholders, by considering the tax influencers behind share incentive plans which are being indirectly moulded by the tax legislation, drafted by National Treasury and implemented by SARS. This report will consider the taxation of income earned *qua* employee versus the income *qua* shareholder. In order to consider this the paper will attempt to determine where the line currently rests between employee and shareholder, by providing an outline of the current legislation around share plans and some of the commonly seen share schemes implemented in practice. This paper will then consider the direction that this line is moving, if at all, by considering the proposed changes to the legislation as drafted by Treasury and lastly consider how these proposed legislative changes impacts corporates who are trying to implement a long term share incentive plan.

- Keywords: Share incentive plans, section 8A, section 8B, section 8C, section 10(1)(k)(i)(dd), Bosch and Another v Commissioner for South African Revenue Service 75 SATC 1

Declaration

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

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Kirsten Hunt

31st December 2013

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Chapter 1 - Background and introduction of share incentive plans

Introduction

It is commonly understood that it is the people in the organisation that hugely affect the efficiency and work environment, which ultimately brings about greater profitability and value in the organisations. In the past, it may have been common for employees to consider spending an entire career in one organisation, but in more recent times, employees are keeping an eye on the job market and have been seen to move organisations with greater frequency.[1] This trend, it is submitted, is a result of the improved awareness by employees of the power of the employee in the employer / employee relationship. As a result of this trend, corporates are having to consider more effective techniques of attracting and retaining high performing individuals to their organisations. Employees consider a multitude of different factors when considering whether they are interested in moving organisation, such as the working environment, the people that they work with etc., however this paper will focus on the remuneration incentive of a share incentive plan and the link to securing employees for a longer term as well as aligning the interests of the employee with those of the shareholders. In addition, this paper will focus on the effect that the tax legislation is having on the divide between remuneration *qua* shareholder and *qua* employee.

The King Report on Governance for South Africa 2009 ('King III') makes it clear that in order to maintain good corporate governance, while trying to attract and retain high performing employees, the company's remuneration policy must be efficient and competitive. King III emphasises the importance of remuneration in the following key principles:

- Companies should remunerate directors and executives fairly and responsibly.
- Companies should disclose the remuneration of each individual director and prescribed officer.
- Shareholders should approve the company's remuneration policy.

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[1] Jeanne Meister, *Job Hopping Is the 'New Normal' for Millennials: Three Ways to Prevent a Human Resource Nightmare*, Forbes magazine August 2012

Aligning the interest of the employees with those of the shareholder

There is a well-established principle in corporate governance described as the 'agency problem' or conflict of interest between management and the shareholders within organisations. Simply put, the 'agency problem' stems from the fact that companies are owned and controlled by different classes of people, namely, the shareholders own the company and the directors control the company.

Ultimately, shareholders of the company want to maximise their return either by the receipt of dividends or through capital growth in the value of the shares they own. Conversely, directors of an organisation want to improve their own personal conditions, by improving their working environment and increasing the reward that they extract out of the company, both of which increase the expenditure of the company and potentially reduce profits or extract value from the company. This commercial driver of trying to align directors objectives with those of the shareholders has resulted in a variety of mechanisms that allow directors to receive part of their remunerations though an incentive which is linked to the growth of the shares or maximising dividends. It is submitted that the introduction of share incentive plans was borne out of the ideas created to address the 'agency problem' by attempting to align the interest of the employees with those of the shareholders by providing an incentive to employees which is linked to the benefits received by the shareholders, i.e. by making employees partial 'owners' of the company.

This debate has many aspects, but chief among the elements around this debate is how to effectively remunerate the directors in order to align the objectives of the directors with those of the shareholders. One such solution that has been used to align these objectives is the use of share incentive plans.

In addition, corporate entities have commercial drivers to set up and implements share incentive plans based on the following objectives:

- Creating an environment where employees can enjoy the growth of the company in order to identify with the progress and prospects of the company.
- Trying to structure any share incentive plans so as to minimise the tax burden (including fringe benefits tax) of holding the shares in the participant's hands.
- Incentivising employees to remain in the employ of the organisation for an extended period.
- Protecting the participants from potential downside losses.[2]

[2] Professor T.E. Brincker, 'Taxation principles of Interest and other Financing Transactions', LexisNexis, May 2011, at page S-3

Treasury and SARS are well aware that share incentive plans, if not controlled effectively, could incentivise employees and corporates to reclassify employee's remuneration, if it would result in the employee paying less tax. Ultimately the struggle between the conflicting interests of Treasury and corporates, leads to a tug-of-war over how these share incentive plans should be taxed.

This report will consider the taxation of income earned in the capacity as an employee versus the income of a shareholder. In order to consider this the paper will attempt to determine where the line currently rests between employee and shareholder, by providing an outline of the current legislation around share plans and some of the commonly seen share schemes implemented in practice. This paper will then consider the direction that this line is moving, if at all, by considering the proposed changes to the legislation as drafted by Treasury and lastly consider how this impacts a corporate trying to implement a long term share incentive plan in an environment where the tax legislation is constantly being amended. In considering the above this report will consider the concept of 'the line', which is the concept of having the proverbial defined 'line in the sand' which provides guidance on the different tax treatments of falling on either side of the line. In this paper, the contemplated divide is between the tax treatment of being a shareholder in a company (receiving dividends, taxed as such) and an employee (receiving remuneration, taxed as such). It is therefore considered whether, in tax terms, it is possible for one person to interact with a company in both of these capacities, or whether the legislation 'favours' a single capacity.

Taxation and share incentive plans – where is the line drawn now

General principles of share incentive plans

Share incentive plans ultimately lead to an additional amount being received by the employee on which the employee is then taxed. Obviously, the employee is incentivised to be a part of a share incentive plan that is structured in a tax efficient manner. However, the company is not merely the entity that establishes and operates the share plan, but is also incentivised to set up the share incentive plan in a tax efficient manner in order to maximise the after tax cash incentive that it is providing its employees. Share incentive plans would be ineffective if there was a low level of uptake by employees due to the fact that the employees would be negatively impacted by the tax effects of the incentive plan. Stated differently, if the share incentive plan resulted in a worse tax position by the employees than a simple bonus, the employees would then prefer to have bigger bonuses, and defeat the objective of the share incentive plan which is to attract and retain key individuals, and to create value in the organisation.

The tax take by SARS when comparing the different methods of financial benefit to employees, i.e. in the form of shares and dividends rather than a simple cash bonus, has only a slight effect on the total tax collected by SARS, unless the legislation reclassify payments. Stated differently, where an employer pays a bonus to its employee, the payment is deductible in the hands of the company at 28% and included in the employees taxable income to be taxed at the respective marginal rate (up to 40%). On the other hand, where dividends are paid, the company is not permitted to take a deduction, and the employee is taxed at 15%. The total difference in the amount received by the fiscus using the maximum marginal rate and amounts of R100 can be seen below.

Payment as a R100 cash bonus			
	Calculation	Tax effect	
Company tax deduction	100*28%	R	-28
Taxable in the employee's hands	100*40	R	40
Tax take by SARS		R	12

Payment as a R100 dividend			
	Calculation	Tax effect	
Company tax deduction	0	R	-
Taxable in the employee's hands	100*15%	R	15
Tax take by SARS		R	15

The above table is simplified in that it does not cater for the tax effect of issuing the shares (which can lead to a tax deduction for the company, discussed below), and, for example, an amount being included as income by the employee in terms of section 8C. However, the overall point can be seen, which is that the payment of dividends does in fact result in a higher amount of tax accruing to SARS in any event, without any reclassification of income.

Mechanically, the taxation of share incentive plans is administered by the employer in terms of the Fourth Schedule to the Act (PAYE). The Company therefore has an obligation to understand the tax effect of whatever share incentive plan is set up in order to administer its tax affairs correctly. The failure to withhold the correct tax could result in the corporate entity being liable for the tax in addition to the employee, jointly and severally.[3]

The employer - employee relationship

For purposes of sections 8A, 8B and 8C where share incentive plans are being contemplated, it is a prerequisite that the participant have an employer-employee relationship. The specifics of each section are worded differently, however the existence of an employment relationship must exist in each of the above sections. In other words there must be a nexus between the award and employment of the employee by the employer. Where the shares are provided for a reason other than such a relationship the transaction would have to be considered in terms of the provisions of the Income Tax Act outside of sections 8A, 8B and 8C.

[3] In terms of paragraph 4 of the Fourth Schedule to the Income Tax Act.

Section 8A - The old line in the sand

The expiry date of section 8A is likely to be approaching fast, as in terms of the Revenue Laws Amendment Act 32 of 2004, section 8A only applies where the participant received a right to acquire shares prior to 26 October 2004. Since most share incentive plans provide that the option exists for a maximum of 10 years, it is likely that section 8A will, for practical purposes very rarely find application near the back end of 2014. However, this report will continue to consider the tax implication of such options granted before 26 October 2004.

Section 8A, was brought into the Act in order to tax employees should the employer issue shares to the employee below market value. Section 8A deemed the difference between the market value and the amount paid to be included in the taxpayer's income.

Section 8A applies to any marketable security[4] that is exercised, ceded or released during such year, if such right was obtained by the taxpayer before 26 October 2004. Section 8A goes on to state that any gain made by the taxpayer on the exercise of the right is included in the taxable income of the taxpayer.

In terms of section 8A(3) the amount to be included in the taxpayers income is either:

- The difference between the consideration given by the taxpayer for the marketable security (including any consideration given for the right of the granting of the option) and the market value of the marketable security, or
- If the gain is made by a cession or release of a right to obtain a marketable security, the amount by which the consideration received by or accrued to the taxpayer exceeds the amount or value of any consideration given by the taxpayer for the right or the grant of such right

This can be seen through the use of examples:

Example 1: Where the employee is given an option to acquire shares for R100, that are being traded for R150, the gain, being the R50 is included in the taxable income of the taxpayer.

Example 2: Should shares be offered for a price of R100, which is the market value on the date of the offer, however, by the time the offer is accepted the market value has risen to R150, again the R50 will be included in the taxpayer's taxable income.

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[4] Including stocks, securities, debentures, shares or other interests capable of being traded on a securities market.

It is submitted that the crucial date on which section 8A would deem the taxpayer to have received / accrued income, would be the date upon which the option is exercised / accepted by the taxpayer.

As it has been stated before, the objective of share incentive plans is usually twofold, to incentivise the employee to remain in the employ of the company for specific terms, as well as to align the financial interest of the employee with those of the shareholders. In order to achieve the first objective, the shares incentive plan usually contains a mechanism which only provides the employee the full benefit of the share after a 3-10 year period. This can be achieved by placing restrictions in the trust deed of the share trust, through the use of a deferred delivery plan, financial penalties should the employee not achieve certain criteria etc. Accordingly, in many of the cases where the restrictions lift, or shares are delivered, the employee may wish to 'cash-in' on the incentive at the expiry of the term. Should the employee then sell the shares into the open market (or potentially back to the trust), the employee should be aware that the sale will be subject to normal tax principle, i.e. either the employee will be required to pay income tax on the proceeds or the proceeds may be subject to CGT on the difference between the base cost and the consideration received.

The strict interpretation of the above provision, lead to tax planners developing the deferred delivery share incentive plan, which allows for a small upfront gain to be taxed as income with the majority of the gain only occurring in the future, and taxed as CGT at the lower rate. Typically, such an incentive plan would offer shares to the employee at market value on day 1, with a short window in which to accept the shares, commonly 6 months. Should the employee accept the offer, which in most cases the employee invariably does, section 8A deems the gain on the difference between the offer price and the market value of the shares on the acceptance date to be included in taxable income. This gain is typically a smaller gain, with the majority of the gain to be received at a later date, the deferred delivery date. The deferred delivery mechanism would then state that the shares would be delivered at a time in the future, potentially at multiple times in the future, for example after 3, 5 and 7 years. The shares are, in addition, only paid for on delivery. Typically after three years, the share price has increased and the participant is able to pay for the first tranche of the shares at the market offer price made over three years in the past. Only once the participant sells the shares, would the participant pay the tax on the difference between the purchase price on day 1 and the price at which the shares are sold in the future. It is also likely that the tax liability would be

on CGT and therefore a lesser amount of tax is paid on the gain (as opposed to income tax at the marginal rate). In the *Bosch*[5] *case* below, this principle is considered in further detail.

After 26 October 2004 – the line in the sand shifts

On 18 February 2004, the Minister of Finance announced that specific legislation would be introduced to combat situations where top executives were manipulating their remuneration packages to maximise the capital gains tax, by participating greater in share incentive plans and minimise the income tax expenditure, by taking a lower salary, thus paying less overall tax on the same package. Thereafter section 8B and 8C of the Income Tax Act was introduced to combat the rapidly evolving equity based incentives offered to executives.

Section 8B– Broad-based share incentive plans

Section 8B of the Act was introduced by the Revenue Laws Amendment Act 32 of 2004. The provisions of section 8B provide a tax incentive for a broad-based share incentive plan, subject to certain criteria. Specifically, the shares must be equity shares, available for acquisition by 90%[6] of employees[7] and must be acquired at par value. [8] Should the qualifying shares be held for a least 5 years, even should the employee leave prior to the expiry of 5 years, the gain on the disposal of the shares will be subject to CGT and will not be regarded as income in the employee's hands. On the contrary, if the shares are disposed of within the 5 year period, the gain will be included in the income of the employee (or ex-employee as the case may be). It should also be noted that should the employee not dispose of the share in its entirety but a right comprising of the share, the employee would be taxed on the disposal of that right. For example, should the employee dispose of the right to receive a dividend, that receipt would be included from an income tax perspective.

The wording of the section 8B is stated in the reverse, in that section 8B includes amounts into income subject to certain provisions rather than setting out circumstances where income tax will not be paid. Specifically, section 8B states, where an individual disposed of the shares in the company within 5 years section 8B deems the amount to be included in the income of the individual in terms of subsection 1, subject to meeting certain requirements.

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[5] Bosch and Another v C:SARS [75 SATC 1 (WCHC, November 2012)]
[6] Later decreased to 80% during 2008.
[7] Employees that have been employed, on a full-time basis, by the company for at least a year and are not permitted to participate in any other share incentive plan offered by the company, or some or other reason.
[8] Professor T.E. Brincker, '*Taxation principles of Interest and other Financing Transactions*', LexisNexis, May 2011, at page S-25

By SARS's own admission there was an apparent lack of usage of this incentive, which resulted in a review being conducted to determine its shortcomings. It was found by SARS that Industry viewed the terms of the incentive as overly restrictive, thereby preventing any practical use thereof. The main concern determined by SARS was that the R9 000 'ceiling' was too low given market conditions (e.g. the administrative burden of the implementation of a plan that would qualify for the incentive outweighed the benefits that could be derived from it). The 'ceiling' was therefore increased to R50 000. Other concerns also existed, such as the required participation of 90 per cent of employees.[9]

In terms of the amendments made to section 8B in 2008, additional clauses were introduced to deal with the strict interpretation that could result in negative tax consequences where the disposal was as a result of 'no-fault' by the taxpayer. For example, where the shareholder dies or is declared insolvent the tax would be calculated on a CGT basis. In addition, where the individual is granted other equity shares in exchange for 'qualifying equity share[s]', as defined, for other equity shares, the other equity shares are deemed to be 'qualifying equity share[s]'.[10]

The so-called 'ceiling' amount of R50 000 over a five year period is calculated using the market values on the date of granting the shares, taking into consideration the preceding 4 years. The date of granting is the date on which the shares are approved by the directors or some other person or body of persons with comparable authority conferred under or by virtue of the memorandum of incorporation. [11] for example if R2 000 shares are granted in year 1, none in years 2 and 3, and R40 00 in year 4, with another tranche of R8 000 in year 5, the total shares granted over the 5 years would fall within the 'ceiling' amount of R50 000 in terms of section 8B of the Act.

Section 8C- The new 'pencilled in' line

Background

As a result of, *inter alia*, the various planning techniques employed by corporates and their advisors devising plans and variations of share incentive plans to specifically avoid tax in the employees hands, SARS and Treasury realised a change in the law was required to deal with these avoidance plans. In 2004, Treasury released legislation to 'enhance'[12] the taxation of equity instrument fringe benefits in order to eliminate, then current, tax advantageous plans. This lead to the release of the first version of section 8C, which focus was focused on the 'vesting' date rather than the date of the

[9] Notes to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008
[10] Section 8B(1) of the Act, as amended
[11] Professor T.E. Brincker, '*Taxation principles of Interest and other Financing Transactions*', LexisNexis, May 2011, at page S-26
[12] As described by Treasury in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004

'right to acquire' (employed by section 8A) equity. In order to curb confusion, section 8C is only applicable after 26 October 2004, in terms of its effective date. Section 8A, conversely only applies to any right to acquire any marketable security obtained by the taxpayer prior to 26 October 2004.[13]

Section 8C came into effect as of 26 October 2004, and effectively was Treasury's attempt to include gains and losses attributable to employees and directors, in relation to shares, in terms of a share incentive plan, on revenue account (no matter how the plan was structured and whether the shares were held directly or indirectly[14]).

> 'The tax system has long sought to address executive share plans that seek to undermine the tax base by converting executive bonuses into a variety of employer share arrangements. The most recent legislation targeting this form of avoidance is section 8C, which seeks to ensure that restricted share arrangements result in ordinary revenue for employees when applicable restrictions are lifted.'[15]

Fast forward four years after the introduction of section 8C, and Treasury (with SARS) is still grappling with structuring techniques employed by corporates and their advisors specifically designed to avoid tax through the implementation of variations of share plans. In 2008, the ambit of section 8C was extended by widening the scope of the term 'equity instrument' (section 8C(7) – 'equity instrument' definition). This new definition includes 'any contractual right or obligation the value of which is determined directly or indirectly with reference' to the underlying share. Hence, section 8C now applies to an interest in a trust even if the employee has a right solely to the value of the shares in the trust (without any direct right in the shares themselves).

Without going into each of the various iterations of section 8C of the Act, the law as it currently stands is discussed below.[16]

Equity instrument

As a result of the ongoing battle for territory being played by Treasury (and SARS) and corporates (no doubt with the assistance of their advisors), the legislation around the taxation of share incentive plans has been through various iterations, which inevitably have caused some uncertainty as to where the law is and will be in years to come. One has to spare a thought for the corporate entities

[13] In terms of section 8A(1)(a) of the Act
[14] In terms of later versions of section 8C of the Act
[15] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008
[16] Including the amendments in terms of The Taxation Laws Amendment Act, 2013

which have no intention of trying to 'work the system' but merely trying to comply with this constantly changing landscape.

As a starting point it should be highlighted that other sections of the Act with their tax consequences are specifically excluded by section 8C. Specifically, the deeming provisions of section 9B and 9C which state the disposal of shares which have been held for more than a specified period are deemed to be of a capital nature, are not applicable. In addition, section 23(m) which limits the deductibility of expenditure in relation to employment or the holding of an office. Accordingly, losses suffered are thus still claimable by the taxpayer on the vesting of the shares.

It is still a fundamental requirement that the equity instrument is an equity share[17], a financial instrument that is convertible to a share, or any right or obligation the value of which is determined directly or indirectly with reference to a share. In addition, the equity instrument must be acquired by the taxpayer as a result of employment or office held by the issuer or an 'associated institution', as defined. [18]

The above definition of an equity instrument is, it is submit, very wide as a result of various mechanisms that have been employed in the past to fall outside of the ambit of section 8C. The widening of the scope was made in 2008, to, *inter alia*, cater for the growing use of trusts in the implementation of share incentive plans and the technical avoidance of section 8C, where trusts involved executives obtaining rights which would equal the value of shares held by the trust without ever providing the executive with access to the shares.[19]

Vesting

A key concept introduced by section 8C is the interpretation of 'vesting', upon which the section is concentrated around, and moves away from the concept of transfer of ownership.[20] Accordingly, the taxing event does not take into consideration the transfer of ownership or the delivery of the share, but only on vesting. Accordingly, shares could be transferred by the employee taxpayer prior to vesting and not tax would occur in terms of section 8C of the Act. Accordingly, the understanding of when vesting occurs is key to considering the tax effects of section 8C on the share incentive plan.

The date of vesting is dependent on whether the equity instrument is restricted or not. If there are no restrictions on the equity instrument, the vesting of the equity instrument occurs on acquisition

[17] Accordingly, the share will not fall under section 8C if the share is a preference share or other class of share that is not an 'equity share' as defined in section 1 of the Act
[18] Section 8C(1)(a)(i) of the Act
[19] In terms of the Revenue Laws Amendment Bill, 2008
[20] Upon which section 8A was based.

of the equity instrument. Professor Emil Brinker states that acquisition passes on the date that ownership of the unrestricted equity instrument passes to the taxpayer.[21]

However, where the instrument is restricted, the vesting occurs on the earliest of the following dates[22]:

1. Once the last restriction is lifted / fulfilled.
2. Immediately before the taxpayer disposes of the restricted equity instrument.[23]
3. When the equity instrument terminates when it is still an option or a financial instrument.
4. Immediately before the taxpayer dies, if all the restrictions relating to the equity instrument are or may be lifted on or after death.
5. Disposals as contemplated in subsections (2)(a)(i) and (2)(b)(i), which are disposals back to the employer (or associated institution or other person) by arrangement for an amount that is less than market value.

Should a gain be made on the vesting of an equity instrument the amount would fall within the definition of remuneration in the fourth schedule and would be subject to Pay As You Earn ('PAYE'). Similarly if a loss was made (which is not usual due to the existence of 'stop-loss' clauses in the agreements) the loss would be deductible for income tax purposes.

Restricted equity instruments

Understanding the definition of a 'restricted equity instrument' is key definition in determining the date the tax is payable, and is defined in section 8C(7) as an 'equity instruments' (discussed above) subject to one of the following:

(a) A restriction that prevents the taxpayer from freely disposing of the equity instrument at market value.

(b) A restriction which results in the taxpayer forfeiting ownership below market value or being penalised financially for not complying with the terms of the contract.

(c) If in the terms of the agreement any person retains a right to impose a restriction as described in the above two bullets.

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[21] Professor T.E. Brincker, '*Taxation principles of Interest and other Financing Transactions*', LexisNexis, May 2011, at pageS-38

[22] Professor T.E. Brincker, '*Taxation principles of Interest and other Financing Transactions*', LexisNexis, May 2011, at pageS-38 & S-38-1

[23] Unless the disposal is in terms of the equity swap rules or the rules in terms of disposals not at arm's length to connected persons rules

(d) An option to acquire a share which is a restricted equity instrument.

(e) An option to acquire a financial instrument capable of being converted into a restricted equity instrument.

(f) If the employer, associated person or other person in arrangement with the employer has undertaken to cancel the transaction or purchase the shares at a price higher than market value on the date or repurchase, if there is a decline in the market value – the so called 'stop-loss' provision.

(g) If there is a provision which defers the delivery of the shares pending the happening of an event, whether or not that event is certain or not.

Determining the inclusion upon the vesting of the equity instrument

The amount that will be included in income for purposes of section 8C will be the amount that the market value exceeds the consideration paid for the equity instrument on the vesting date. Should the consideration paid exceed the market value on the vesting date a loss will be incurred by the employee (subject to their being no 'stop-loss' provision in the agreement).

For example, if A Company gives an option to an employee to purchase 100 shares for R1 each and the employee accepts the option subject to a deferred delivery Plan of 3 years (i.e. the shares are restricted). On the expiry of the 3 years the employee pays the R100 for the 100 shares, however, on the same date the shares are valued at R3 each (i.e. a total market value of R300), then the employee will have to include the difference between what he paid and the market value, in income (i.e. the R200) and pay the appropriate marginal rate (which would be in the form of PAYE withheld by the employer).

CGT consequences

Continuing with the example above, should the employee dispose of the shares acquired after the three year delayed delivery for R700 a few months later (in the same tax year), the employee would experience the following tax consequences for CGT purposes:

- The base cost of the shares in the employee's hands would be equal to the market value on the vesting date.[24]
- The proceeds would not be deemed to be market value.[25]

[24] In terms of paragraph 20(1)(h)

Accordingly, the employee would pay CGT on the difference between the actual price received for the shares (R700) and the market value on the vesting date (R300). The difference (R400) would be dealt with in terms of general CGT principles (i.e. 50% would be included in the taxable income and taxed at his marginal rate).

Distributions in relation to section 8C instruments

With effect from 1 April 2012 capital distributions are included in income that are received or accrued to a taxpayer which are as a result of a restricted equity instrument in the year of assessment that they are received.[26] Traditionally, capital distributions would be considered part disposals in terms of the Eighth Schedule to the Act and taxed at the lower CGT rate where a taxpayer holds shares in a company.[27]

In addition, and more significantly, was the amendment to section 10(1)(k) of the Act which 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, generally speaking, (A) the restricted equity instrument constitutes an equity share, (B) the dividends constitute an equity instrument, or (C) the restricted equity instrument constitutes an interest in a trust, and the trust holds equity shares.

Due to the focus that Treasury and SARS has placed on this specific section in recent years, more detail and a discussion on this point is made in more detail below under Chapter 2. However, in principle it would seem that SARS may wish to include dividends received in relation to equity instruments in income received via share incentive plan's going forward.

Due to the significance of the *Bosch*[28] case and clarity it provides by discussing the application of section 8C, it is explored in detail below.

The Bosch[29] case – The Courts provide some clarity on the line

The *Bosch case* was an appeal from ITC 1856[30] considering an appeal by the recipients of the Foschini share incentive plan. The purpose of the share plan was to give employees an incentive to contribute to the growth of the company by aligning the financial benefit the employees receive with that of the shareholders. The share incentive plan that was implemented by Foschini operated on the basis that options would first be granted to participants before shares could be bought (Day

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[25] In terms of paragraph 38(2)
[26] In terms of section 8C(1A), introduced by Taxation Laws Amendment Act 24 of 2011
[27] Subject to the exclusion of capital distributions in the form of equity instruments.
[28] Bosch and Another v C:SARS [75 SATC 1 (WCHC, November 2012)]
[29] Bosch and Another v C:SARS [75 SATC 1 (WCHC, November 2012)]
[30] Income Tax Case No 1856, 74 SATC 76.

1). The options that were granted to the taxpayers, to acquire shares at stipulated prices, were exercised shortly after being granted. The gains that usually arose on the exercise date, due to the short delay between the granting of the option and the exercise of the option, were usually limited (Day 2). The taxpayers did not have to pay the purchase price upon the exercise of the option, but only on delivery of the shares (Day 3). This was a typical, co-called, deferred delivery share incentive plan that was common practice prior to the introduction of section 8C of the Income Tax Act.

Prior to the delivery of the shares the taxpayers rights were limited, in that they could not alienate, transfer, cede, pledge or encumber rights in terms of the shares. The risks and benefits of the shares did not pass until they were registered in the name of the taxpayer. The taxpayer could not exercise or dispose of any voting rights and lastly a stop loss provisions was included (i.e. the shareholders would have the option to sell the shares to the trust subject to certain conditions if the shares were worth less than the purchase price).

In 2011, the tax court held that section 8A of the Income Tax Act applied only at the point at which the shares were paid for and delivered (i.e. on Day 3 when the greatest gain was usually made).

The matter then went on appeal where the High Court re-examined the meaning of the words 'right to acquire'. The court dismissed a strict legal understanding of the word 'right' in favour of a broader notion of rights, as was adopted in the *Kirsch*[31] *case* on the interpretation of the 'right to acquire' in section 8A of the Income Tax Act (as it was then). This is the same approach adopted by SARS ever since the *Kirsch case.*

In addition, had section 8A been drafted to mean that 'acquire' does not take place until the participant had fulfilled his or her obligations, then there would be no need for section 8C to distinguish between a restricted and unrestricted instrument.

The Court held that the deferral clauses in the agreement do not render the sale subject to suspensive conditions and therefore the unconditional sale of the shares took place on the exercise of the option (i.e. on Day 2 when less of the gain was made).

It appears that SARS was made to concede the above point in court and then sought to rely on the substance over form of the transaction and argue that the transaction was simulated (with reference to the *NWK*[32] *case*). According to SARS, prior to delivery there was sufficient fundamental uncertainty as to whether the deferral sale would be implemented to justify the conclusion that

[31] Secretary for Inland Revenue v Kirsch [1978] 3 ALL SA 308 (t)
[32] C:SARS v NWK Ltd [2011] 2 All SA 347 (SCA)

there was no unconditional right to the shares. The High Court applied the *NWK*[33] *case* to the extent that one must look at the commercial rationale or sense of the transaction. Where the form of a transaction attempts to present a commercial rationale, but there is no commercial rationale, and the sole purpose of the transaction is to avoid tax, then the principles in NWK should be applied. The mere fact that a transaction aims to achieve the avoidance of tax, does not as such make it a simulated transaction. The High Court concluded that the share incentive plan had a commercial rationale.

In conclusion, the High Court overturned the ITC by deciding that section 8A applied when the options were exercised, not when the shares were delivered.

Clarity on the interaction of section 8A and 8C

At paragraph 122 Allie J, with reference to SIR v Kirsch 2978(3) SA 93(T), notes that for purposes of Section 8A of the Act, whether an employee accepts an offer for the sale of shares or exercises an option to purchase the shares, both would be the exercise of a right to acquire shares. Importantly, he held at paragraph 117 that 'in the context of Section 8A, it is not the mere right but the acquisition pursuant to the grant of that right which brings with it the possibility of financial gain. Having regard to the environment in which Section 8A was introduced, the clear purpose of Section 8A was to tax employees who bought shares at less than market value by either accepting offers for the sale of the shares, or by accepting options to purchase the shares'. Accordingly, Section 8A is triggered when a gain is made and in the case of deferred delivery plans, the gain is only finally quantified once delivery occurs as this is when acquisition of the shares is complete. In other words, in the context of a deferred delivery plan, Section 8A may only be triggered on the delivery of the shares to the employee.

Taxpayers party to a deferred delivery plan should therefore carefully analyse whether the gain realised on the actual delivery of the plan shares are subject to tax in terms of Section 8A or Section 8C of the Act (which applies to shares acquired by way of the exercise of any right granted before 26 October 2004 in respect of which Section 8A applied). The particular facts of the Tax Court case are helpful to appreciate the issues at hand. Share options had been granted to the taxpayer in August 1998 and December 1998 and the shares were only to be delivered on 14 August 2004 and 2 December 2004, respectively. The gain (if any) realised on the initial exercise of the option would have been subject to income tax in terms of Section 8A. However, based on the finding that Section 8A may be triggered on the deferred delivery of the shares, it was held that:

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[33] C:SARS v NWK Ltd [2011] 2 All SA 347 (SCA)

- Section 8A of the Act applied to shares delivered on 14 August 2004 (before 26 October 2004); and
- Thereafter Section 8C would apply to the shares delivered on 2 December 2004. Taxpayer s should therefore carefully analyse their historic or current participation in deferred delivery share incentive plans to determine whether they have correctly disclosed any gains or potential gains in terms of Section 8A and Section 8C of the Act.[34]

Australian tax case consideration - A glance over our borders

In many cases it is useful to consider the approach that is being taken outside of South Africa in order to consider the reasonableness and international consistency of the approach within South African borders. In addition it can provide some useful assistance as to how other countries are dealing (or dealt) with issues that currently face us in South Africa.

In an Australian case[35] considering the tax consequences for a Mr Sent revolving around the implementation of a share incentive plan. In this case Mr Sent was a managing director and chief executive officer. In 2001 Mr Sent qualified for three bonuses, some of which were due and payable, others had periods that had been partially completed, and the last related to services still to be performed by Mr Sent. Mr Sent and the employer agreed that he would waive his claim to the abovementioned bonuses in exchange for 5 million ordinary shares in the employer. On 30 November 2001, the shareholders agreed to the issue of the shares to Mr Sent. In December 2001, the employer established a trust into which AU$11.6 was paid for the purpose of extending loans to employees to acquire units in the trust. In the current case, the money was applied to Mr Sent to apply for units in the trust. The consideration received by the trust for the units was to be used exclusively to acquire shares in the employer. The units could not be cancelled by Mr Sent for the first year held. Various arguments where put forward to the court to determine whether Mr Sent had received his bonus payments and whether the payments were due or still subject to restrictions.

However, the court held that it was not correct to consider Mr Sent's rights as contingent at the time of the payment, due to the fact that the original bonuses were still contingent of services to be provided. In November 2001, when the shareholders approved the issue of the shares to Mr Sent, Mr Sent acquired an unconditional entitlement to the shares. The court went on to state that once the share issue deed had been executed, and approved, the contingent rights that r Sent previously had, were replaced by an unconditional right to the shares.

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[34] Andrew Lewis, Deferred delivery plans scrutinised, Moneyweb's Tax Breaks, November 2011
[35] Sent v Commissioner of Taxes (2012) FCA 382 (Australia)

Having considered the facts of Mr Sent in light of section 8C it is likely that had Mr Sent implemented this arrangement in South Africa, similar tax consequences would have flown as the vesting would have likely occurred once he had an unconditional entitlement to the shares in November 2011, i.e. even before the vesting of the trust units.

The law around share plans in Australia is different from that in South Africa but certain lessons can be learned that are equally applicable in South Africa. The case provides a good example of how the Australian tax authorities are also keeping a keen eye on share plans and the implementation thereof. In addition it provides a good example of the adverse tax consequences that can arise without the proper structuring being implemented. In this case it has been submitted by commentators on the case[36] that had certain restrictions been placed on the vesting of the shares, Mr Sent may have been able to defer the tax to later years of assessment.

Having considered the current law around share incentive plans, the following section will consider some of the common types of shares plans that are implemented in the market, which sets the scene of how corporates are trying to manage the current legislation.

Common types of share incentive plans

Share appreciation rights

Overview

Share appreciation rights (sometimes known as SARs) are one of the mechanisms that companies have used to incentives their participants to align the participant's objectives with that of the shareholder. A share appreciation right gives an participant an entitlement to a benefit calculated with reference to the variation in the market value of the company's shares. At the end of a specified period the share appreciation right would be settled in cash, shares or a combination of both. This type of share incentive plan is differentiated from an option plan, discussed below, by the fact that option plans give the participant an entitlement to shares against payment of an option price. In other words, the shares are not limited to the appreciation in the market value.

As an example, if the employer company shares are valued at R300 each, on the date of entering into the plan and the shares are worth R900 each on the delivery date, the participant is entitled to the appreciation, being R600. This R600 can be settled in cash or by the delivery of shares to the value of R600.

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[36] Andrew Lewis, *Taxing share incentive plan benefits*, Moneyweb's Tax Breaks, June 2012

Transaction steps to the plan

1. Employer company awards participants share appreciation rights which would entitle the participant to a payment in future equal to the growth in the value of the employer company's share.
2. The share awards payment to the participant equal to the growth in the market value of the shares from the start date of the participants incentive mechanism date to date of award made to the particular participant, provided that on the second date the participant meets certain performance criteria, which may include merely still being an participant or could include additional performance criteria.
3. The quantum of the award to the participant is calculated with reference to share appreciation over the period, but the formula may also be affected by other performance measures and other factors as appropriate for the specific company.
4. On the vesting date, the participant may elect to either call for delivery of x amount of shares, equal to the growth in the share price(as per the appropriate formula) or receive cash settlement equal to the growth in the value of the shares (again as per the appropriate formula).

Commercial factors

Advantages

- If the structure is cash settled, it would not create a dilution of the shares in the company.
- This type of share incentive plan is more popular in bull markets (i.e. where the shares are generally increasing in value)
- Aligns executive management with the shareholders' interests.
- Assists in retaining valued participants, who would lose the incentive should they elect to leave.
- Is administratively simple, especially if cash settled.
- If participant incentive mechanism is equity settled it would limit the effect on the profit and loss volatility.

Disadvantages

- In a bear market, the plan would not work well (i.e. where the share price is not increasing in value).
- If the award is cash settled, it could result in profit and loss volatility.

- If equity settled, the market shares would be diluted.
- If equity settled, shareholder body increases and therefore implementation and administration is more complex.

Tax considerations

Generally speaking, such a plan would result in the participant having to account for the receipt in gross income in the year that the participant is unconditionally entitled to the shares/cash payment in terms of section 8C (in the case of shares) and as a receipt as contemplated in 'gross income' (for cash settlement).

However, the employer company would be required to withhold the participants tax (PAYE). If the award is cash settled the employer company could take tax deduction. However, where the award is share settled, it may be necessary to consider the use of a trust in order to facilitate the share incentive plan in order to allow the company to claim a tax deduction (discussed further under the heading 'The use of trusts in the facilitation of share incentive plans' below).

Performance shares

Overview

Performance share incentive plans are long term incentive plans that deliver free shares to the participant on a date in the future, commonly referred to as the 'vesting date'. This award is often structured as a conditional right to acquire shares or as a nil-cost option to the participant. As is common to most types of share incentive plans, the award is linked to performances and vests after a period of time, to the extent that the performance criteria are met.

As an example, if the employer company shares are valued at R300 each, on the date of entering into the plan and the shares are worth R900 each, on the delivery date, the participant is entitled to the same number of shares as on day one which would be 1 share valued at the full R900[37]. This R900 can be settled in cash or by the delivery of shares to the value of R900.

Transaction steps to the plan

1. The employer company awards the participant with a conditional right or nil-cost option to acquire/receive shares in the future.
2. The employer company delivers the shares on the delivery date, to the extent that the participant meets the performance criteria and is still a participant on the delivery date.

[37] The difference between this mechanism and the share appreciation right is that the participant is entitled to the entire share and not just limited to the increase in value from the first date.

Commercial factors

Advantages

- The plan works well in both bull and bear markets
- The plan incentivises participants in tough financial times
- The plan caters for the ability to impose performance conditions to further incentivise the participants.
- Aligns executive management with the shareholders' interests.
- Assists in retaining valued participants, who would lose the incentive should they elect to leave.
- Can be implemented quickly and easily.
- If the participants incentive mechanism is equity settled, profit and loss volatility would be limited.
- True equity participants incentive mechanisms[38] are often preferred by both participants and employers in aligning interests of management and shareholders

Disadvantages

- Shareholders may not like the idea of giving shares away for 'free', so the performance conditions and criteria need to be attached.
- If the performance criteria are too onerous, the plan may become a disincentive to participants.
- The size of the shareholder body increases and therefore implementation and administration can become more complex.

Tax considerations

Generally speaking, such a plan would result in the participant having to account for the receipt in gross income in the year that the participant is unconditionally entitled to the shares/cash payment.

However, the employer company would be required to withhold the participants tax (PAYE). If the award is cash settled the employer company could take tax deduction. However, where the award is share settled, it may be necessary to consider the use of a trust in order to facilitate the share incentive plan in order to allow the company to claim a tax deduction.

[38] As opposed to 'phantom' plans which are equity linked but no shares are ever issued

Forfeitable share plan

Overview

Forfeitable share incentive plans are long term incentive plans that deliver free shares to the participant at the beginning of the share plan period. These share shares are subject to conditions, which if not met, result in the participant forfeiting the shares back to the company (or share trust). These forfeiting criteria will usually at least include the requirement that the participant is still employed for a specified time period, but may also include other specific performance criteria. While the shares are held by the participant, the participant receives dividends and is entitled to capital growth in respect of the shares delivered.

It is also possible to set up the plan using a cash settlement structure at the end of the designated period.

Transaction steps to the plan

1. The shares are delivered to the participant (or held in trust on behalf of the participant) on the implementation date of the share incentive plan.
2. The participant, for the duration that the share is held, received dividends from the shares held.
3. Provided the participant continues to meet performance criteria, the participant continues to enjoy the benefits of the shares.
4. Should the participant leave the employ of the employer company (or fail to meet any other performance criteria), the shares are forfeited back to the company (or share trust).

Commercial factors

- The plan works well in both bull and bear markets
- The plan incentivises participants in tough financial times
- The plan caters for the ability to impose performance conditions to further incentivise the participants.
- Aligns executive management with the shareholders' interests.
- Assists in retaining valued participants, who would lose the incentive should they elect to leave.
- If the participants incentive mechanism is equity settled, profit and loss volatility would be limited.

- True equity participants incentive mechanisms[39] are often preferred by both participants and employers in aligning interests of management and shareholders

Disadvantages

- Shareholders may not like the idea of giving shares away for 'free', so the performance conditions and criteria need to be attached and strictly adhered to.
- If the performance criteria are too onerous, the plan may become a disincentive to participants.
- The size of the shareholder body increases and therefore implementation and administration can become more complex.

Tax considerations

Similar to the above structures, such a plan would result in the participant having to account for the receipt in gross income in the year that the participant is unconditionally entitled to the shares/cash payment.

However, the employer company would be required to withhold the participants tax (PAYE). If the award is cash settled the employer company could take tax deduction. However, where the award is share settled, it may be necessary to consider the use of a trust in order to facilitate the share incentive plan in order to allow the company to claim a tax deduction.

Deferred annual bonus plan

Overview

The deferred annual bonus plan involves the deferral of part, or all, of a participant's annual bonus by applying such bonus to purchase shares in the company. The shares purchased by the participant with the participant's bonus may be restricted for a period of time ('deferred plans') or not restricted ('unrestricted shares'). The majority of plans involve matching shares, in addition to the deferred shares or unrestricted shares, at the end of the specified period, which effectively serves as a retention mechanism. Deferred annual bonus plans can potentially meet investor's requirements to better align the senior executives' interest with those of shareholders by providing a means of building longer term equity stakes in their own company with the retention element. Deferred annual bonus plans can also effectively address participants concerns of financial risk, the majority

[39] As opposed to 'phantom' plans which are equity linked but no shares are ever issued

of new plans that are implemented provide matching shares which are conditional on the achievement of further performance conditions over the deferred period.

Transaction steps to the plan

1. The shares are offered to the participant for a specified time, at the price as at the date of the offer.
2. The participant within the specified time accepts (or rejects) the offer of the shares, however delivery and payment for the shares is delayed until a future date (for example 3 years).
3. Once the three years have lapsed, the participant pays for the shares and takes delivery.
4. Usually there will be a 'stop-loss' clause in the sale of the shares contract, which, for example, may allow the participant to sell the shares to the share trust at the same purchase price that the participant acquired the shares, in order to ensure the participant does not have to realise a loss on the purchase of the shares.

Commercial factors

Advantages

- Strong retention elements.
- Considered the best practice plan in the United Kingdom and increasingly in South Africa.[40]
- Favoured by investors, due to the own investment by staff.
- Flexibility to use performance conditions.
- Increased alternate compensation forms.
- Participants participate with high level of financial risk but on a basis that the funding of the initial cash flow is less onerous.
- Helps link short terms decisions to longer term performance.
- Further aligns interest of management and shareholders by encouraging management to 'pay to play'.

Disadvantages

- Take up rates may be low.
- If performance conditions are too stringent, the plan may become a disincentive.

[40] According to KPMG's UK survey of Directors' Compensation 2012

- The plan can result in a significant increase in the size of the overall remuneration package, if the annual bonuses are increased to facilitate compulsory deferral bonuses.
- More suited to senior executives.
- Second tier management bonuses are typically insufficient.

Tax considerations

Similar to the above structures, such a plan would result in the participant having to account for the receipt in gross income in the year that the participant is unconditionally entitled to the shares/cash payment.

However, the employer company would be required to withhold the participants tax (PAYE). If the award is cash settled the employer company could take tax deduction. However, where the award is share settled, it may be necessary to consider the use of a trust in order to facilitate the share incentive plan in order to allow the company to claim a tax deduction.

Broad-based participant share plan

Overview

The Broad-based employee share plan is a less common type of share incentive plan implemented for the additional benefit it provides to the company to attract and retain certain qualifying individuals to the company. This plan not only assists by aligning the individuals financially to the shareholder, but also assists the company to meet certain regulatory requirements in South Africa by employing BEE candidates as well as increasing the BEE ownership of the company.

Transaction steps to the plan

Provided the broad-based share plan meets the requirements specified in the Income Tax Act, some of which are listed below, the plan can be implemented in a number of ways.

1. Employees must directly acquire 'equity shares'[41] in the employer company.[42]
2. Employees may only be restricted from selling the shares for 5 years (i.e. the employees can only be locked in).
3. The market value of the shares may not exceed R50 000.[43]

See the discussion of section 8B of the Income Tax Act below for more detail.

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[41] A requirement embedded in the definition of a 'qualifying equity share' in section 8B of the Income Tax Act.
[42] The use of a trust is therefore difficult to use in these broad based share incentive plans.
[43] A requirement embedded in the definition of a 'qualifying equity share' in section 8B of the Income Tax Act.

Commercial factors

Advantages

- Aligns the participant with the shareholders, not only on a financial basis but also assists the company to reach higher BBBEE regulatory requirements.
- Encourages qualifying candidates to join organisations with the specific plan.

Disadvantages

- Seldom implemented due to the strict requirements.
- Limited to individuals who qualify under the specific broad-based criteria.

Tax considerations

Provided the terms of the plan meet the specific requirements set out in the Act, broad-based employee shares plans override the normal tax principles of taxation, in that the participant is not taxed when the share is acquired, nor when the restrictions are lifted, but only when the share is disposed of by the participant. In addition the disposal is only subject to income tax if the share is disposed of within 5 years from the date of granting it. For more specific detail around these types of plans see the discussion around section 8B of the Income Tax Act discussed under

Variations or hybrid share incentive plans

The above share plans have a number of overlapping factors and benefits which should be considered by the employer company prior to deciding on the most appropriate share incentive plan to suits its particular needs. However, in practice, companies frequently create hybrid structures or mould one of the above common share incentive plans to suite its particular purpose. In many cases the hybrid or variation to the plan can set off alarms for outside third parties like SARS who either do not know how to treat the hybrid structures for tax purposes or take aggressive positions against the hybrid structures as they do not like the fact that these hybrids may create tax advantages for the employer and participants.

The use of trusts in the facilitation of share incentive plans

In many cases where a share incentive plan is implemented, the use of a special purpose share trust is incorporated. The incorporation of the share trust has many benefits which are not only limited to tax. Having the shares held by the trust makes the share incentive plan administratively easier to run in a separate vehicle. There is also more certainty in the shareholding of the company and the company is not required to continuously, on a piece meal basis, issue new shares as and when shares are subscribed for by participants. In addition, the share trust would be a separate entity and

therefore insolvency remote. Lastly, the trust deed itself is a useful tool which provides cautious tax planners an opportunity to structure the conditions, obligations and performance requirements for the transfer of ownership of the shares, or now with the introduction of section 8C, the vesting date of the shares.

Practically speaking the trust is incorporated for the benefit of a class or specific employees, depending on the structure of the share incentive plan. The employee company usually makes a contribution to the Trust in the form of cash. The employee company is in most cases permitted to take the contribution as a tax deduction, given the fact that the contribution is for the benefit of its employee. The Trust then uses the funds received as a contribution to subscribe for new shares or to purchase shares in the market, which shares are held in trust on behalf of the specific employees pending the fulfilment of the incentive plan requirements. Such requirements usually include continuous employment and performance criteria. During the existence of the share plan, the dividends received in relation to shares held either are passed onto the specific employees or used to repay the loan account that was established on the share acquisition. The trust allots the shares or the benefit to the specific beneficiaries as and when the restrictions lift.

It is however, noticeable in practise that due to the changes in legislation that trust are being used less, and rather a set of rules are established in the employer company and an appointment letter is granted to the employee stated the terms and amount of the share incentive. The employer company rather than establishing a trust makes a contribution to a third party who acquires shares on behalf of the participant. Such a structure also usually results in the contribution to the third party, being deductible in the employer company.

Section 40 of the Companies Act

Section 40 of the Companies Act[44], states that the board of directors may issue authorised shares only should adequate consideration be provided to the company in return. Previously, the old companies act stated that the consideration should be at par value, but in the new Companies Act this guidance is absent. The question then arises as to what adequate consideration is in each scenario, and it appears that this would be considered on a case by case basis by the directors of the board. In the case of a share incentive plan it could be argued that adequate consideration may be less than market value (or at a discount) if the directors apply their minds and consider the consideration adequate in the circumstances. However, it is not inconceivable that this could be subject to an attack from SARS, should shares be issued for little to no consideration.

[44] The Companies Act, 71 of 2008

Having set the scene of the current law and the common types of share incentive plans that are seen in the market, it is important to remind ourselves that the purpose of these plans, commercially speaking, is to align the interest of the employees with the interests of the shareholders, as well as incentivising the employee to remain at the current employer. What we can see from the legislation that has been discussed above is that there are a myriad of options available to employers which slightly incentive or are structured differently. However, the key elements to the share incentive plans are; the fact that although delivery may not occur on day 1, usually the employee benefits from the growth in the share price and dividends on day 1. The actual delivery of the share is either delivered on day 1 with a claw back, which reverts ownership to the employee, or the shares are delivered at the end of a term, once restrictions have lifted. As the law currently stands while the employee does not have full ownership of the share the benefits that he gets from being an 'owner' are different because he seems to continue to be employed by the organisation, as a shareholder would not be taxed on returns of capital, but a holder of the unvested shares would.[45] However if the shares did not have the limitation on them, i.e. full ownership has not passed, the shareholder is 'punished' with an additional tax burden due to the fact that the employer wants to incentivise the employee to work for an extended period. As the law currently stand this additional tax burden on employees can be avoided by declaring dividends rather than returns of capital, as currently these are not taxed 'differently' to ordinary shareholders. However, should it be the policy to require directors of organisations have to have to apply their minds to distributions for fear of penalising employees? We continue to consider this question below, but first, we discuss the mechanics of the organisations employee's tax obligations that are already in place.

Employer withholding and reporting obligations

Income tax

In terms of paragraph 11A of the Fourth Schedule to the Act, the employer is required to withhold employees' tax on the gain made as a result of the vesting of an equity instrument as contemplated in section 8C. As discussed above, 'vesting' for purposes of section 8C would be on the exercise of the SARs.

An 'employer' is defined as any person who pays or is liable to pay any person an amount by way of 'remuneration'. For the purposes of this opinion the 'employee' is defined to include the director of a company. For purposes of deciding an employer's obligation to deduct or withhold amounts in

[45] Section 8C(1A) of the Act

respect of any gains realised on the exercise of SARs, the relevant employer is the employer by whom the SARs were granted

The employer company must ascertain from the Commissioner the amount of employees' tax which must be deducted from the amount of the gain made on the exercise of the SARs. A tax directive application must be submitted to SARS.

The employees' tax withheld must be remitted to SARS together with an employees' tax return on or before the seventh day of the month following the month in which the option is exercised. The employer company is required to disclose the amount of the gain and the tax withheld (as is the case with all other remuneration) on an employee's annual tax certificate (IRP5), a copy of which must be furnished to the employee and to SARS.

Social taxes

The following 'social taxes' will be payable by the employer company on the taxable value at the time of the taxable event:

The Skills Development levy is 1% of the gain and must be remitted together with the income tax withholdings to the tax authorities by the 7th day of the month following the month in which the gain is realised;

The employer Unemployment Insurance Fund contributions amount to 1% of remuneration up to R149,736 per annum (R12,478 per month) and must also be remitted together with the income tax withholdings to the tax authorities by the 7th day of the month following the month in which the gain is realised.

For purposes of Workmen's Compensation Fund contributions, the employer must declare to the Department of Labour earnings of all employees up to a maximum of R214,305 per annum per employee at the end of each tax year. The Department of Labour will issue an assessment based on the industry the employer company operates in.

Employee Unemployment Insurance Fund contributions are payable by the employee on the gain, and must be withheld by the employer. The contribution will amount to 1% of remuneration up to R149,736 per annum (R12,478 per month).

Employer Corporate Tax Deduction

Having set the scene of share incentive plans, and outlined the mechanics of the employer's tax obligations, we take a moment to consider the tax position for the employer, i.e. whether the

mechanics of the distributions and the share incentive plan have a tax effect for the employer directly. As already stated above, the tax around share incentive plans revolves primarily around the employee's income tax position, which affects the employer due to its withholding tax obligation; however, depending on the mechanics and proper implementation the employer organisation may be able to take the deduction for its expenditure.

General comments

The following is a brief overview of the relevant provisions that govern the operation of a share incentive plans, based on the below facts, in so far as they have an impact on the corporate tax deductibility.

It is presumed that the employer companies would be consider to be conducting a trade, and the participants are employed by the respective companies for purposes of that trade and for the purpose of producing income for the respective companies.

In practice, the Remuneration Committees undertake the operational decision-making relating to the governance of the incentive plan. The Committee, therefore, has the final authority to decide, by means of a resolution, who will participate in the share incentive plan, the quantum of the awards to be made to the participants, the nature of the performance conditions to be imposed, and all other issues relating to the governance of the plan.

The relevant companies remain responsible to procure the settlement of the benefits in terms of the plan to the participants employed by them on the vesting date, subject to the participants remaining in the employment of the respective companies until such dates.

Only when settlement is to be effected to participants in terms of the plan, will the quantum of the relevant companies' responsibilities materialise. The relevant companies can then elect which settlement method is to be implemented, such as:

1. to make the required cash payment to a third party, on the basis that the third party will acquire the required number of shares in the market for delivery to the participant; or
2. to subscribe for shares in the company either at par value or at market value; or
3. the relevant company will pay the equivalent amount in cash *in lieu* of any shares.

The tax legal principles relevant to obtaining a corporate tax deduction may briefly be summarised as follows.

For the purposes of determining the taxable income derived by any person from the carrying on of any trade, section 11(a) of the Act provides that there shall be allowed as deductions from the income of such person so derived, expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature ('the general deduction formula').

Section 23(g) must be read with section 11(a). The former section prohibits the deduction of any expenses to the extent that such moneys were not laid out or expended for the purposes of trade. (To this extent, it is deemed necessary to ensure that an obligation arises for the relevant companies to incur the expenditure).

SARS is entitled to disallow *inter alia* remuneration expenditure to the extent to which it is excessive, on the ground that the expenditure is not actually incurred in the production of the income, as required by section 11(a), or is not laid out or expended for the purposes of trade, as is required by section 23(g).[46]

In terms of section 23H the deduction in terms of section 11(a) of expenditure actually incurred for services rendered during a year of assessment, may be limited where all such services will not be rendered during the year of assessment in which the expenditure is incurred. The effect of this section is to spread the deduction over the period during which the benefit of the expenditure will be enjoyed (this may equate to the vesting period).

In some circumstances the employees are incentivised by listed shares in a holding company. In these circumstances the expenditure, if expensed by the holding company is usually on charged to the employer company in order for the deduction to rest in the correct entity.

Accordingly, the contribution or payment by the employee company, is usually tax deductible, provided the incentive plan and payment is properly considered and implemented.

[46] For example ITC 1530 (1990) 54 SATC 261 at 268, ITC 1518 (1989) 54 SATC 113, ITC 569 (1944) 13 SATC 447 and ITC 575 (1944) 13 SATC 476

Chapter 2 – Amendments to the Act…the line moves further

Recent amendments

Although there were no amendments made to sections 8A, 8B or 8C[47] in the recent Taxation Laws Amendment Act, 2013[48], there have been some noteworthy changes to the sections in the Act in the past as well as the initial draft amendment bill for 2013, which illustrate the focus of Treasury to address any possible areas where previously, in Treasury and SARS' opinion, there has been a tax leakage. The Base case study 1 below in Chapter 3 contemplates the changes that were introduced in 2008 and the typical uncertainty that an employer company would be required to clarify. Some of the noteworthy amendments of the past few years are discussed below.

With effect from 1 April 2012 capital distributions to the holder so section 8C instruments are included in income in terms of section 8C(1A). This was a significant change in 2011, as prior to this date both dividends and capital were distributed to the participants in share incentive plans without attracting any tax. It is submitted that this change was quite significant, as it creates a worse tax position for receiving capital distributions as a shareholder as opposed to an employee with section 8C shares. In any event, with proactive planning, the capital distributions can be rather declared as dividends, as currently these are still tax exempt.

In terms of amendments to section 10(1)(k) dividends are exempt from income unless they are in respect of a dividend in respect of a restricted equity instrument contemplated in section 8C, subject to three exclusions. Stated differently, if the dividend falls into one of the following three categories, the dividend will (still) be exempt income.

The first exemption is that if the restricted equity instrument constitutes an equity share, the dividend will be exempt income. Conversely, if the restricted equity instrument does not constitute an equity share, the dividend is not exempt income.

The second exemption is where the dividend itself constitutes an equity shares. It is thus important to note that an equity share is defined in the act as a share that entitles the owner to participate, without limitation, in the dividend distributions of the company or entitles him to participate, without limitation, in a liquidation distribution of the company. Accordingly, where the company issues further equity shares to the taxpayer, the additional equity shares would be a dividend and accordingly, exempt income in the hands of the taxpayer.

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[47] Save for the minor amendment dealing with the reference to the Companies Act 71 of 2008
[48] Published on 13 December 2013

Lastly, the third exemption provides that the restricted equity instrument constitutes an interest in a trust and the trust holds only equity shares, the dividends received would be exempt income. Due to the fact that in practise, most share plans involve the use of trusts which hold the shares in trust on behalf of the taxpayer, this provision usually allows for the dividends to be exempt in the employee taxpayers hands.

Looking at the changes that SARS has implemented in 2008[49] and 2011[50], it would appear that SARS is constantly monitoring the large corporate entities and their share incentive plans in order to shut down perceived tax benefits that share plans are provide employees. Such a trend has continued in 2013[51] which draft bill is discussed in more detail below.

What the recent draft amendments[52] can tell us about where Treasury and SARS want to move the line.

Having considered the proposed amendments suggested by Treasury in the Draft Amendment Bill 2013, there are many criticisms which can be made as to the effectiveness of the amendments, the technique used to effect the change in policy as well as the policy adopted themselves. It would appear that after inviting the public to provide comments on the Draft Bill, 2013, Treasury and SARS agreed that their initial thoughts may require further consideration, as most of the proposed legislation was never carried though into the Bill or Act. By considering the proposed changes that Treasury and SARS are looking to bring in the future, to better understand the direction that legislature is looking to take the tax policy. The following are some of the criticisms that can be made of Treasury's attempt to change section 8C and its linked legislative provisions. Generally speaking the amendments are not trying to relax the taxation around share incentive plans, but rather an attempt by Treasury to close perceived gaps in the legislation.

While it is understandable for the proposed amendments to subject dividends in respect of restricted equity instruments to tax, the proposed manner this was to be achieved was clumsy and unnecessarily complex. It was not necessary to amend the 'gross income' definition in relation to such amounts as such amounts are already included in gross income. All that is effectively required is to deny the exemption for such dividends in section 10(1)(k).

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[49] The Revenue Laws Amendment Bill, 2008
[50] Taxation Laws Amendment Act 24 of 2011
[51] The Draft Taxation Laws Amendment Bill, 2013
[52] The Draft Taxation Laws Amendment Bill, 2013

Such a precedent already exists in this regard section 8C(1A) which subjects returns of capital in respect of restricted equity instruments to tax while section 10(1)(k)(i)(dd) denies the dividend exemption for dividends on restricted equity instruments. All that is required is to remove the exceptions from this denial relating to equity shares in items (A) and (C).

It is submitted that the same effect could be achieved by rather deleting items (A) and (C) of section 10(1)(k)(i)(dd) in order to give effect to the above intention.

A further criticism of the proposed changes is the apparent departure from policy, for which no indication was given in the 2013 Budget Speech, and which is contrary to previous indications from Treasury on this matter. On page 22 of the Explanatory Memorandum to the draft Taxation Laws Amendment Bill 2013, the stated intention of the proposed amendments is to address the disguising of high-taxed salary as low-taxed dividends (that is not tax deductible for employers).

Commercial considerations

The Explanatory Memorandum to the draft Bill seeks to assert that the dividends which are sought to be taxed operate as salary, regardless of the features of the underlying share. This assertion fails to consider the main feature of such share plans, which is the participation of the employees in the equity of the company, and a shared alignment of (often executive) interests with the interests of the shareholders. This is particularly appropriate in the case of public companies, where the participants of a long-term incentive plan are subject to performance conditions relating to the financial performance of the company for the vesting of the restricted shares. The intention of the long-term incentive plan is therefore that participant employees obtain direct control of the shares, subject to company financial performance. The dividends declared to participants of the share plan on the restricted shares, are therefore the same as for any other shareholder, and the purpose of the dividends is not to disguise high-taxed salary as dividends.

A fundamental principle of many businesses is that staff should think and take accountability like owners and not like employees. As it is imperative that staff and shareholder interests are aligned, these share plans are therefore not intended to be a salary conversion plan (i.e. the mischief which the proposed amendments seek to address) but rather aims at encouraging staff ownership.

Furthermore, in some instances longer vesting periods are preferable from a retention perspective. The proposed taxation of dividends arising from restricted equity instruments would however create tension with staff as dividends received in respect of restricted section 8C instruments would be taxed for a longer period of time. Again, the intention is not to be a salary conversion plan and all

shares will ultimately vest in the employees, the purpose is merely to provide an income stream to beneficiaries as part of the staff ownership structure.

Share plans are also often established to facilitate the implementation of Broad-based Black Economic Empowerment ('BEE'). To empower BEE staff and reinforce a staff ownership philosophy, third partner BEE partners are often not part of a BEE share plan. If these dividends are now subjected to income tax in the hands of the employees, it would be discriminatory against such employees, as the dividends would have been exempt if an outside third party was used.

Simply from a commercial perspective, the proposed amendments would be contrary to the purpose of share plans, specifically from a staff ownership, retention and BEE perspective.

The stated intention of the amendment is to address the disguising of high-taxed salary as low-taxed dividends (that is not tax deductible for employers). It is submitted that the following are the reasons why the proposed amendment do not properly address this concern:

In public companies it is not possible to manipulate dividend flows in the manner suggested; and Page 22 of Draft Explanatory Memorandum on the draft Taxation Laws Amendment Bill of 4 July 2013

For public companies, in almost all instances the underlying shares or restricted shares awarded in terms of the employee share plan are holding company shares and not the shares of the employer company (operational entity). As a result of this the corporate tax deduction ostensibly afforded to the company declaring the dividend in terms of the newly proposed 11(t) is at the wrong level / incorrectly matched. Note that it is in any event not clear, if section 11(t) is read with the opening words of section 11, whether it is indeed the company declaring the dividend that is also regarded as 'the person' referred to in the opening words of section 11(t), being the person entitled to the deduction.

Regarding the first point, as public companies are unable to manipulate dividend flow to specific shareholders, due to their inherently large numbers of shareholders and the nature of public companies, it is submitted that the proposed amendment does not address the mischief it sets out to address insofar as it relates to public companies. The likelihood of employee share plans being used to effectively 'dividend strip' within the context of public companies is therefore unforeseen.

In terms of the second point, the full intention of the legislature is not achieved through the amendment, as the amendment does not facilitate the matching corporate tax deduction for the employer company of the participant to the share plan. Instead, the amendment contemplates a

deduction for the granter of the dividend, which in a group structure is often a holding company for the investments in its subsidiaries (the employer company/ies).

Such a holding company may be a non-operating company, or passive holding company, which will have no 'trade' for the purposes of which the expense could be deemed to be incurred. It is a requirement of section 11 of the Act for taxable income from which deductions are permitted to have been derived by the taxpayer by the carrying on of a trade. It would therefore not make sense for such a passive holding company to have a deduction, where there is little to no income from which to make the deduction, and where the company does not carry on a trade as required. For this reason, the matching of the ordinary revenue with the deduction by the company declaring the dividend is not a true matching which achieves the restoration of vertical equity, as is suggested in the Draft Explanatory Memorandum.

Rules of employee share plans are often drafted to provide for a number of settlement methods which include the potential for the incurral of costs by the 2 Page 23 of Draft Explanatory Memorandum on the draft Taxation Laws Amendment Bill of 4 July 2013 employer company in the settlement of the benefits to which the participants become entitled to in terms of the plan. Accordingly, the dividends paid to participating employees should be deductible by the employer company of the relevant participant in order to match the income tax deduction (and vertical equity) sought to be implemented.

Accordingly, the matching deduction for the company should be for the employer company, not the company declaring the dividend.

Administrative implications

Under the current system, STRATE withholds the dividend tax payable, and the net dividend is paid to the shareholder. Under the new proposed system, it is unclear how STRATE will distinguish between normal dividends paid which are subject to normal dividend tax, and dividends paid in terms of restricted shares (from employee share plans), which will be subject to income tax.

It is assumed that such dividends from restricted shares will be identified and paid by STRATE in full to the employee; however, the company will bear the responsibility to withhold the income tax payable. Accordingly there should be a system by which STRATE is able to identify dividends which are declared for restricted shares'.

It is assumed that a new taxable code will be created which will be used for payroll and tax certificates (IRP5) and will be a 'payment in kind' source code as opposed to a true taxable income source code.

Employees' tax disclosure

The unvested dividend is included in both paragraph (d) and paragraph (c) of gross income and it is unclear when it will fall within the ambit of paragraph (d) (termination of employment) rather than under paragraph (c) of gross income.

The importance of this is in respect of the disclosure on the IRP5 which would have different code and paragraph (d) also requires the employer to ascertain the employees' tax via a tax directive.

It is submitted that it should be clarified when para (d) will apply. For example, if not already included in para (c), it is included in para (d).

Deduction of dividend

The deduction in s11(t) should not be linked to inclusion in gross income under para (c) or (d). Most dividends are included in gross income by virtue of being of a revenue nature without any reference to the special inclusions. As such, these dividends will arguably never qualify for deduction under the proposed provisions.

It is recommended that the deduction simply be linked to the revised exemptions for dividends and foreign dividends on restricted equity instruments as proposed above.

It is submitted that deduction for dividends should apply to any dividend or foreign dividend in respect of a restricted equity instrument that is included in income. While the granting of a deduction for such dividends is to be welcomed in the interests of equitable treatment, it should be noted that in most instances the company paying the dividend and the employer are not the same person. For example, a listed company may have numerous subsidiaries in which the businesses are conducted and may not have any income itself against which to deduct the amounts.

The deduction should therefore be for the employer of the person in question and not for the company paying the dividend.

Are the amendments addressing the right issues

In the report by the Standing Committee on Finance it was agreed that:

> 'In the main, the proposal was found to be too broad, impacting on bona fide employee share plans, and leading to inequity. Response: Accepted. It is

> agreed that the proposal was overly broad and that it exceeded the policy intent. The concerns raised in the submission were taken into account and the proposal was significantly narrowed.' [53]

There seems to be an apparent misconstruing of the purpose of employee share plans by SARS and Treasury. The Draft Explanatory Memorandum seeks to assert that the dividends which are sought to be taxed operate as salary, regardless of the features of the underlying share. This assertion fails to consider a main feature of such share plans, which is the participation of the participant in the equity of the company, and a shared alignment of (often executive) interests with the interests of the shareholders. This is particularly apt in the case of public companies, where the participants of a long-term incentive plan are subject to performance conditions relating to the financial performance of the company for the vesting of the restricted shares. The intention of the long-term incentive plan is therefore that participant employees obtain direct control of the shares, subject to company financial performance. Therefore, the dividends declared to participants on restricted shares are the same as for any other shareholder, and the purpose of the dividends is not the disguise of low-taxed salary as dividend yield, but the alignment of shareholder value creation.

The implications for employee share trusts

The Explanatory Memorandum indicates that employee share trusts are expected to be taxed on dividends received. However, there would appear to be a fundamental misunderstanding of how employee share trusts work and how section 8C effects the tax implications thereof.

As a general matter, shares held by employee share trusts do not fall within the provisions of section 8C as they are not acquired by the trust by virtue of employment. The equity instrument associated with an employee share trust to which section 8C applies is the beneficial interest in the trust which is then acquired by an employee by virtue of employment. It is therefore the beneficial interest in the trust held by the employee that is subject to section 8C and not the shares held by the trust itself. Where dividends received by the trust are vested in the beneficiary they will retain their nature as such in terms of the conduit pipe principle.

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53 Standing Committee on Finance: Report-Back Hearings 11 September 2013, Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013

Chapter 3

Base case study 1 – Moving the Goal posts

Although the legislation surrounding share incentive plans has been considered in some detail, through the use of specific facts, this paper will proceed to consider the impact that changing laws has on established share incentive plans already in place, as well as a scenario where a taxpayer can still create a situation to mitigate the tax on a share incentive plan.

The below is an example of a typical analysis that would be required to be undertaken by a corporate when treasury implement wording changes to legislation around share incentive plans, specifically, section 8C. The slight word change considered below, it is submitted, is usually made in order to close a perceived threat to the fiscus. However, as can be seen, usually cause corporates to experience discomfort with established share plans and the additional burden of incurring costs to seek clarity on the changes and potential impact on the share incentive plan in place.

Facts

In the proposed share plan, a trust was established to hold shares in the operating or ultimate holding company. For purposes of this base case, the A Trust currently holds 25 per cent of the ordinary share capital in HoldCo. HoldCo in turn holds 100 per cent of the ordinary shares in OpCo; and the employees within the OpCo are beneficiaries of the A Trust (i.e. hold units in the A Trust).

The purpose of the A Trust, is to provide employees within the OpCo group with an opportunity of acquiring an interest in HoldCo as an incentive to their continued contribution to the growth of the OpCo group.

For the purposes of this base case, the beneficiaries are entitled to all moneys received by the A Trust pursuant to the Trust's ownership of the shares it holds in HoldCo, including the proceeds of any sale by the A Trust of those shares (less the cost).

In terms of the proposed scenario BidCo intends to buy an effective 65 per cent of HoldCo (the 'Acquisition').

As part of the Acquisition, BidCo will acquire all the ordinary shares held by the A Trust in HoldCo.

Potential exposure under section 8C of the Act

The important issue which has arisen in the context of the Acquisition is the potential application of section 8C of the Act. Specifically, the question is whether section 8C of the Act may apply in respect

of the proceeds realised on the disposal by the A Trust of all the shares it holds in HoldCo which, in effect, would trigger income tax for the beneficiaries of the A Trust at their marginal tax rates.

Pre- 21 October 2008 Equity instruments

Prior to 21 October 2008, the definition of an 'equity instrument' in section 8C only included (i) shares, (ii) options to acquire shares and (iii) financial instruments which were convertible to shares. In terms of section 11(1)(e) of the Revenue Laws Amendment Act No. 60 of 2008, however, the definition was amended, with effect from 1 October 2008, to include 'any contractual right or obligation the value of which is determined directly or indirectly with reference to a share' acquired on or after 21 October 2008.

The units acquired by the beneficiaries of the A Trust should not constitute (i) shares, (ii) options to acquire shares or (iii) financial instruments which were convertible to shares. Also, although the amendment to the definition of an 'equity instrument' may very well bring the units held by the beneficiaries within its ambit, the amendment is only applicable in respect of equity instruments acquired on or after 21 October 2008. Therefore, any A Trust units acquired by the employees prior to 21 October 2008 should not, it is submitted, qualify as an 'equity instrument,' and any A Trust receipts forming part of the Acquisition and distributed by the A Trust to the employees holding such pre-21 October 2008 A Trust units, should not be subject to the provisions of section 8C of the Act.

It is submitted that any units acquired by the beneficiaries in the A Trust prior to 21 October 2008 should not qualify as 'equity instruments' as defined and should therefore not be subject to the provisions of section 8C of the Act for the reasons stated above.

Post-21 October 2008 Equity instruments

However, owing to the continuous nature of the A Trust, some of the employees may acquire their units after 21 October 2008. It is therefore necessary to discuss a further two reasons why the provisions of section 8C should not be applicable when the Acquisition is given effect.

No vesting of the equity instruments

In terms of section 8C(1) of the Act, a taxpayer is required to include in his or her income any gain determined on the 'vesting' during that year of any equity instrument. In the case of a restricted equity instrument, vesting is deemed to occur, *inter alia*, when all the restrictions, which result in that equity instrument being a restricted equity instrument, cease to have effect.

In casu, the restrictions which cause the units held by the beneficiaries to be restricted equity instruments is the fact that, as is typical in share plans, the units issued to a participant are not transferrable and may not be sold, transferred, ceded or alienated, except in the event of innocent

termination as a result of the death of a participant, in which case the right to hold and derive benefit from Units as contemplated under clause 17.1 may be transferred pursuant to the law of succession

This means, it is submitted, that even after the disposal by the A Trust of the HoldCo shares, the beneficiaries will still be legally bound by the above clause of the A Trust Deed not to freely dispose of their units. In the absence of the above restriction ceasing to have effect, vesting as contemplated above should not be triggered. (Although it is appreciated that there are other vesting provisions in section 8C of the Act, it is submitted that they do not require any further detailed consideration, suffice to say that they too would not be applicable).

Therefore, on this score alone, any A Trust Receipts forming part the Acquisition and distributed by the A Trust to the employees holding post-21 October 2008 A Trust units should not, it is submitted, be subject to the provisions of section 8C of the Act as they will not 'vest' for the purposes of section 8C on the basis that all restrictions have ceased to have effect.

It is noted, however, that regard must be given to section 8C(3)(b)(ii) of the Act which states that a restricted equity instrument is deemed to vest in a taxpayer 'immediately before that taxpayer disposes of that restricted equity instrument'. It is further noted that, notwithstanding the ordinary meaning of the term, the concept of 'disposal' in section 8C(3)(b)(ii) is likely to be interpreted widely. This is because various other provisions in section 8C expressly contemplate a wider meaning, which include the forfeiture, lapse, abandonment and cancellation of a restricted equity instrument. Therefore, under this construction, it may be argued that the beneficiaries' that A Trust interests have, in substance, been disposed of after the Acquisition. This is based on the reasoning that the A Trust units give the beneficiaries the right to receive certain benefits derived from the holding by the A Trust of the HoldCo shares. At the moment in time when all the HoldCo shares are sold by the A Trust, the beneficiaries will have a contractual right which no longer entitles them to any benefits. Hence, it could be argued that, in substance, the beneficiaries no longer have any contractual rights (i.e. they have disposed of their A Trust units).

Taking the above point further, it is submitted that a trust, in law, ceases to exist when there are no longer any assets held by that trust. Therefore, in the event that the A Trust holds no assets, other than its shares in HoldCo, it may similarly be argued that the beneficiaries' A Trust units cease to exist when the A Trust gives effect to the Acquisition (by reason of the A Trust ceasing to exist in law).

No value of the A Trust units

As indicated above, the post 1 October 2008 A Trust units held by the participants must be (emphasis added) 'any contractual right or obligation the value of which is determined directly or indirectly with reference to a share.' Also, section 8C requires that the gain to be included in the income of the beneficiary, is the amount by which the market value of the equity instrument exceeds the sum of any consideration tendered by the beneficiary for such equity instrument.

In the Commissioner for South African Revenue Service v Wyner (2003) 4 All SA 541 (SCA), the court held that (emphasis added):

> 'The respondent's counsel suggested that the discounted offer made to the respondent gave her an interest. He was not able to explain how this occurred. While this was obviously a very attractive offer it had no commercial value in itself. It was an offer made to the respondent only. It could not be transferred to a third party.'

As indicated above, the A Trust units are 'not transferrable and may not be sold, transferred, ceded or alienated, except in the event of Innocent Termination as a result of the death of a Participant....' In fact, in a fall down position due to resignation, dismissal or, the A Trust units are typically reduced to zero without any compensation to the employees and without the employees having any claim against the A Trust or their employers. Under these circumstances, the A Trust units have no commercial value as contemplated in Commissioner for South African Revenue Service v Wyner above. In the absence of such commercial value, such A Trust units cannot, it is submitted, have 'the value of which is determined directly or indirectly with reference to a share,' or a 'market value' as required by section 8C.

Therefore, on this score alone, any A Trust receipts forming part of the Acquisition and distributed by the A Trust to the employees holding post-21 October 2008 A Trust units should not be subject to the provisions of section 8C of the Act.

It is noted that the definition of 'market value' in section 8C of the Act has not been amended since the definition of an 'equity instrument' was extended to include an interest in a trust. As a result, the definition does not specifically deal with the market value determination of an equity instrument which constitutes a trust interest. Notwithstanding this oversight, it is submitted that the intention of the legislature in determining the market value of an equity instrument is apparent, which is to determine the price which could be obtained between a willing buyer and a willing seller at arm's length had the restriction not existed. In other words, in the case of a restricted equity instrument,

the restriction must not impose the determination of the market value for the purposes of section 8C of the Act.

It is further submitted that the case of Commissioner for South African revenue Service v Wyner (2003) 4 All SA 541 (SCA) concerned very different facts and that the case was therefore not necessarily applicable for the purposes of determining the market value of an equity instrument.

However, one must consider the impact of Commissioner for South African revenue Service v Brummeria Renaissance (Pty) Ltd (2007) SCA 99 (RSA) (the 'Brummeria Case'). In this case, the taxpayer company granted rights of lifelong occupation to prospective occupants in return for interest-free loans. Despite the fact that the taxpayer company could not transfer or cede (i.e. translate into money) the right to retain and use the borrowed funds without paying interest, the court held that those rights had a monetary value which must be included in the gross income of the taxpayer.

In light of (i) the apparent intention of the legislature and (ii) the decision handed down in the Brummeria Case, a court is likely to find that the A Trust units do have a market value in the hands of the beneficiaries, even though they legally cannot be transferred.

In conclusion, notwithstanding the above, the issue of what the market value of the equity instruments (i.e. the A Trust units) actually are is a question of fact, which must be determined with reference to the terms of the A Trust Deed.

It is difficult, if not impossible to express any view as to what the market value of the A Trust units would be, suffice to say that it would be determined with reference to the HoldCo shares

Application of paragraph 80(2) of the 8th schedule to the Act

In terms of the A Trust Deed, the HoldCo shares are legally and beneficially owned by the A Trust. Also in terms of the A Trust Deed, the A Trust receipts forming part the Acquisition will vest in the employees holding A Trust units. Therefore, A Trust Receipts forming part the Acquisition should be subject to CGT in the hands of the employees holding A Trust units in terms of paragraph 80(2) of the 8th Schedule to the Act.

On the basis that (i) the provisions of section 8C are not applicable and (ii) that the HoldCo shares are held by the A Trust on capital account, it is submitted that the proceeds from the sale by the A Trust of the HoldCo shares should be subject to capital gains tax in the hands of the beneficiaries of the A Trust in terms of paragraph 80(2) of the 8th Schedule to the Act.

General comments

Although the Acquisition should not, on a strict interpretation, result in a vesting of the A Trust units on the basis that all the restrictions cease to have effect, there is a concern that the A Trust units could potentially vest on the basis that they were 'disposed' of and that consideration should therefore be given to section 8C(3)(b)(ii) of the Act.

There may also very well be a market value for the A Trust units notwithstanding the fact that, legally, they cannot be transferred by the beneficiaries. This market value must be determined independently by an expert with reference to the terms of the A Trust Deed.

Both the SARS' and the courts are of the view that all employee-related benefits should be subject to tax at the employee's marginal tax rate, either by means of section 8C or paragraph (c) to the definition of 'gross income'. This thinking has been expressed in the last two budget speeches, where it was reiterated that employee-related benefits should not escape tax. However, and as this paper considers, when does the receipt from shares lose the nexus to the individuals employment and change to income based on the fact that the individual is a company 'owner'.

In light of the above, the view that the proceeds from the Acquisition are treated as capital gains in the hands of the beneficiaries, is very likely to be attacked by SARS down the line.

In light of the uncertainty of the above situation, such a standard case would likely be sent to counsel for a view and thereafter due to the uncertainty in the legislation, potentially referred to SARS for clarification in terms of a non-binding private ruling. Whether a corporate could in fact receiving a positive (from a tax perspective) binding private ruling from SARS on such an uncertain set of facts, is a further issue, given the view from SARS is usually that tax is payable, as a fringe benefit is being received by the participants.

Private equity case study 2 – Mitigating tax

The above Base case study illustrates the difficulty that is experienced by corporates when legislation is brought in which creates uncertainty and which is untested by the courts. However as is illustrated in this Private equity case study below, the legislation currently does not cater for all the mechanisms considered by more aggressive tax planers seeking to obtain an (arguably) undue tax benefit. It is therefore anticipate that further developments in this area will take place and amendments will follow in the future. The question then remains as to how to set up a 3-10 year share incentive plan today, when you have to guess where the tax legislation will be in the future.

Facts

A private equity partnership is typically set-up between a single anchor partner, being the legally required minimum number of general partners, with other limited partners (three in this case). The limited partners typically are made up of private pension funds and institutional investors, who are limited in their liability, to their contributions made. The private equity partners all contribute cash or assets to the Private equity fund, for use by the Fund, in exchange for their proportionate partnership interest. However, as is typical in such a private equity fund, the general partner who is at risk in excess of his contribution, usually will contribute less for his interest, due to the additional risk that the general partner exposes himself to for his interest in the partnership.

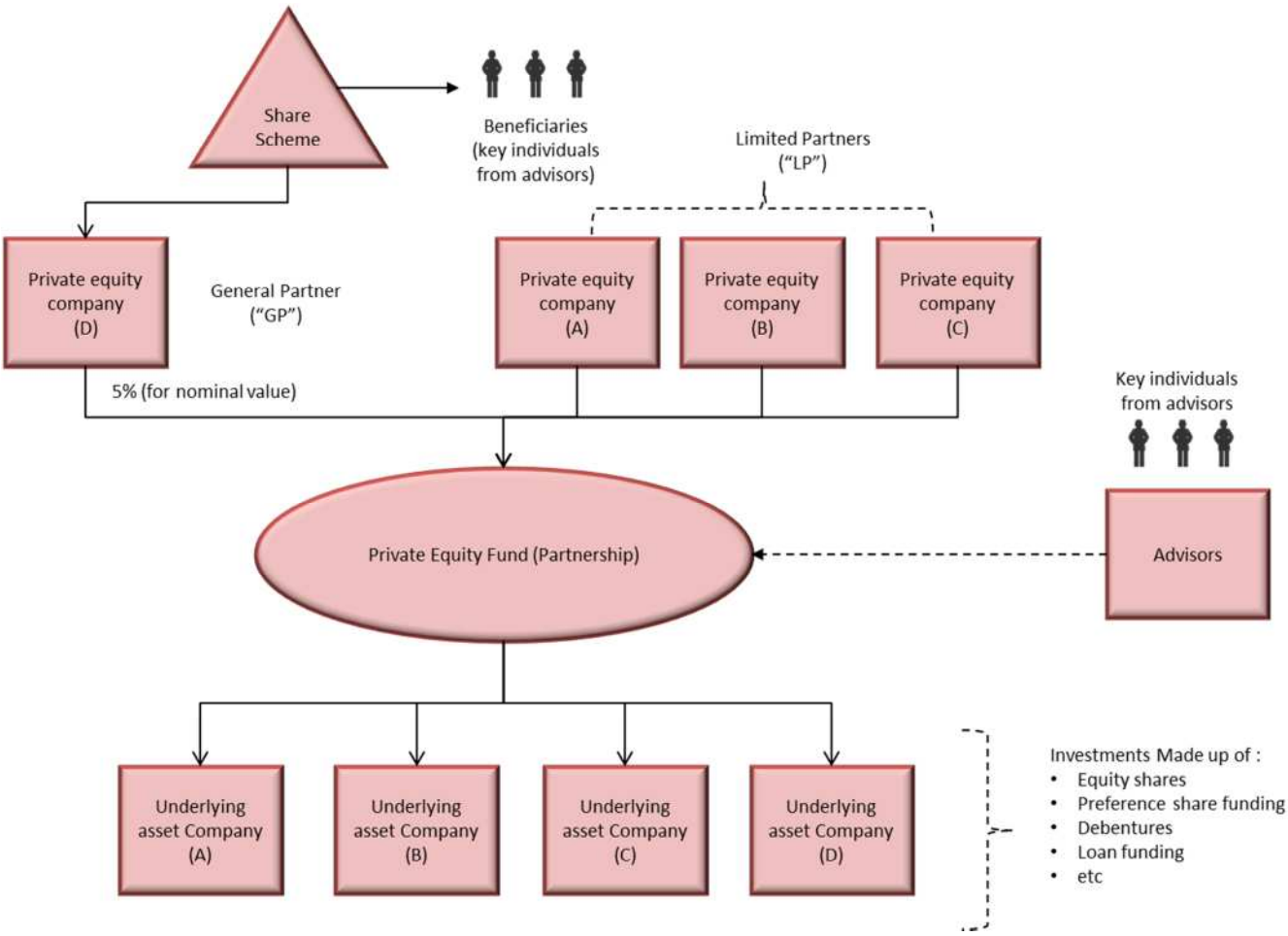
The private equity fund then appoint advisors who would assist the private equity fund from a professional perspective, assisting with the administration of the fund and the acquisition and divestiture of underlying assets. The underlying assets are made up of a variety of asset classes, such as equity shares, preference shares, loan funding debentures etc. in underlying entities.

Holding into the General partner is a Share incentive trust which is set up for the benefit of key individuals / employees of the advisors, based on performance indicators, and other restrictions which result in the interest of the shareholders being classified as 'restricted equity instruments' as defined in the Act. The creation of the share incentive plans allows the key individuals at the advisor company to participate in the upside and align the advisors with the interest of the private equity fund as a whole.

It is anticipated that the private equity fund would exist for 8 years after which the private equity fund will exit from its assets and return the growth to its proportionate partners.

Below is an illustrative diagram of the above structure:

Diagram A



It is submitted that the above structure would be considered a standard private equity structure which would be commonly seen in practise.

Tax considerations – during the existence of the private equity fund

The following are the general tax principles that would flow during the existence of the Private Equity Fund. However the focus of this case study is rather the tax consequences on the dissolution of the Private Equity Fund.

The acquisition of the assets in the Private Equity Fund as well as the acquisition of the respective participants in the partnership would not trigger a tax event, but merely establish expenditure or base costs (where appropriate).

Interest received on loans and debentures would be taxed in the hands of the Private equity companies (A- D), and only in the event that the interest income exceeds any interest expenditure.[54]

The dividends from underlying assets would be received by SA Resident companies and would therefore be exempt from income tax and dividends withholding tax[55]. Further, the dividends distributed by the Private equity company (D) to the share incentive trust would likely be exempt from tax.[56]

Where the private equity fund finds itself with available funds, the funds may be re-invest by purchasing other assets to be held for the purposes of making additional income. The acquisition of these further assets would also not have any tax consequences (other than creating a potential base cost should CGT be applicable).

As can be seen above, the income tax payable during the course of the existence of the Private equity Fund would be limited to the tax on the interest received and the profits made by the trading of assets. Dividends on the distributions made by the underlying assets would be exempt in the hands of the companies and the Share incentive trust.

Tax considerations - on the winding up of the fund

On the expiry of the 8 year period, the underlying assets would be disposed of (i.e. mature or be sold, depending on the nature of the asset). The profit on the sale would be attributed to the respective partners. Although it is not necessarily part of the scope of this report, the respective partners would likely pay CGT on these gains, unless the companies are considered to be plying the trade of dealing in shares 9which depending on the frequency of trades and the intention of the parties may be the case).

The interesting and debatable tax consequence, which is the focus point of this case study, is the fact that depending on the interpretation of section 8C, the general partner could receive the proceeds from the sale of the assets as a dividend to the share incentive trust. The question then arises as to whether the distribution of all the cash to the trust would be a vesting event for purposes of section 8C or merely a dividend declared during the existence of the share incentive plan.

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[54] SARS Practice Note 31
[55] In terms of section 64F(a) of the Act
[56] In terms of section 10(1)(k)(i)(dd)(C)

As discussed under the heading 'Section 8C' subheading 'vesting' above in Chapter 1, vesting is the event that triggers the taxing event of section 8C. As already discussed, the vesting of restricted equity instruments occurs on the earliest of the following dates[57]:

1. Once the last restriction is lifted / fulfilled.
2. Immediately before the taxpayer disposes of the restricted equity instrument.[58]
3. When the equity instrument terminates when it is still an option or a financial instrument.
4. Immediately before the taxpayer dies, if all the restrictions relating to the equity instrument are or may be lifted on or after death.
5. Disposals as contemplated in subsections (2)(a)(i) and (2)(b)(i), which are disposals back to the employer (or associated institution or other person) by arrangement for an amount that is less than market value.

As the taxpayer is not disposing of the restricted equity instrument, the vesting in terms of bullet 2 above, would not occur. Likewise the equity instrument is not terminating (in terms of bullet 3 above), nor is the taxpayer dying (in terms of bullet 4 above). Lastly, the taxpayer is not disposing of the equity instrument back to the employer in any manner, never mind for an amount less than market value (in terms of bullet 5 above).

The question then arises whether all the restrictions in relation to the equity instrument have lifted in order for there to have been a deemed vest. In order to consider this the exact wording of the act should be considered.

> 'An equity instrument acquired by a taxpayer is deemed for the purposes of this section to vest in that taxpayer – in the case of the acquisition of a restricted equity instrument… when all the restrictions, which result in the equity instrument being a restricted equity instrument, **cease to have effect**'[59] (my emphasis)

It is submitted that the key phase to consider and determine whether Section 8C(3)(b)(i) deems there to be a vesting event would be on the interpretation of the bold and underlined words above, 'cease to have effect'. Two schools of thought exist over the interpretation of these words and can

[57] Professor T.E. Brincker, '*Taxation principles of Interest and other Financing Transactions*', LexisNexis, May 2011, at pageS-38 & S-38-1

[58] Unless the disposal is in terms of the equity swap rules or the rules in terms of disposals not at arm's length to connected persons rules

[59] Section 8C(3)(b)(i)

be summarized as follows, for ease of reference the two views have been entitled 'SARS view' and 'Corporates' view'.

SARS view

The first view which the winding up of the investment and payment of a final dividend to the beneficiaries results in there being no possibility that the trust can perform its obligations on the vesting date and therefore emphasis is placed on the word 'effect', as effectively the taxpayer / beneficiary has received the full benefit from the trust, in a quasi-waiver of the restrictions. Stated differently, as the trust has effectively paid out the full benefit to the taxpayer / beneficiary despite their still being restrictions in place, the trust has unilaterally waived the restrictions, which therefore cease to exist and therefore is a deemed vesting date in terms of Section 8C(3)(b)(i).

If such a view is accepted by the courts, it may then create other issues relating to what a final distribution would entail. As throughout the duration of the Private Equity Fund, dividends may be declared which are tax exempt, which may result in the size of the fund decreasing prior to the expiry of the 8 years. What then would be the defining feature of the dividend which would result in a deemed 'final' vesting.

If the final dividend is then going to be treated as a vesting event then it may have to be considered whether the fund should be tapered as it approaches its expiry date. Stated differently, if SARS view is accepted by the court, the fund then may start to reduce the size of the fund earlier in order to reduce the final dividend, which would trigger 8C and the negative tax consequences.

However, SARS view may be moot if, as is suggested in the last draft amendment bill, 2013, Treasury proceeds to have the dividends received in relation to section 8C instruments included in the taxable income of the participant. For further detail around the impact this may have on share incentive plans, see the discussion on the draft amendments bill, 2013 under the heading 'Commercial considerations' in Chapter 2 above.

Corporates view

On the other hand, as the trust continues to exists, as do the obligations that it is required to fulfil once certain performance criteria are met by the beneficiary employee, the restrictions arguably continue to exist, resulting in their being no deemed vesting in terms of Section 8C(3)(b)(i). In terms of this view the only time that the instrument would vest would be either once the trust fails to perform, alternatively when the trust is dissolved. On dissolution, as the trust would not hold any assets, there would be nothing to vest and arguably the beneficiaries would not be deemed to have received. The taxpayer may thus avoid triggering section 8C on the vesting / dissolution date.

Conclusion

For the duration that the private equity fund is in existence the beneficiaries will receive exempt income, if in the form of dividends received from the general partner. As the distribution from the general partner is at its discretion, subject to company law restrictions of solvency and liquidity, it would make sense to make distributions as dividends rather than capital distributions which are taxable as income in the beneficiaries' hands.

In addition, should the Corporates view be accepted, then the dividends will be received without triggering section 8C and no tax would be payable (as the law currently states). Effectively, this would result in the beneficiaries avoiding the provisions of section 8C and only receive exempt income throughout the duration of the private equity fund and on dissolution.

However, if SARS is successful in its argument that the closing out of the private equity fund after 8 years (and final dividend distribution) is a tacit waiver of the restrictions, then the final distribution may be caught by section 8C and subject to income tax. Again, in the event that the SARS view is upheld in court this could create a lot more issues in relation to dividends declared during the lifetime of the private equity fund, or it may just require savvy planning when winding down of the fund (by minimizing the amount of the final distribution, which may be considered a deemed vesting event, should SARS view be adopted).

Chapter 4

Conclusion

SARS and Treasury seemingly continue to consider share plans as tax avoidance plans which are a threat to the fiscus and perceived loop hole. As seen in the latest draft amendments in 2013, it appears that new legislation that is in the pipeline is aimed at widening the scope of the provisions relating to share incentive plans, by both considering the inclusion of dividends in relation to the shares as income (by removing the exemption) as well as potential further amendments to section 8C. It would appear that the direction that Treasury is moving, is to continue to consider share plans as a threat and to aggressively tax amounts associated to the share incentive plans as remuneration. We can only spare a thought for the company which has no intent to defraud SARS, but merely wants to set up a share incentive plan to encourage its employees to take ownership of their company and increase performance by aligning the interest of the individuals with that of the shareholders.

There seems to be an apparent misconstruing of the purpose of employee share plans by SARS and Treasury. The Draft Explanatory Memorandum seeks to assert that the dividends which are sought to be taxed as salary, regardless of the features of the underlying share. This assertion fails to consider a main feature of such share plans, which is the participation of the participant in the equity of the company, and a shared alignment of (often executive) interests with the interests of the shareholders. This is particularly apt in the case of public companies, where the participants of a long-term incentive plan are subject to performance conditions relating to the financial performance of the company for the vesting of the restricted shares. The intention of the long-term incentive plan is therefore that participant employees obtain direct control of the shares, subject to company financial performance. Therefore, the dividends declared to participants on restricted shares are the same as for any other shareholder, and the purpose of the dividends is not the disguise of low-taxed salary as dividend yield, but the alignment of shareholder value creation.

Lastly, as Share plans are also often established to facilitate the implementation of Broad-based Black Economic Empowerment, it is difficult to see how a balance can be struck whereby the legislation does not create an environment where companies would rather prefer to place wealthy employment equity partners in a position to gain more wealth rather than creating a share incentive plan that could empower the very individuals that are within the organisation, due to the restrictive taxing environment. Such a scenario would appear to be counter-productive to the policy of government.

Having said the above and discussed the planned movement of the legislation by Treasury, it would seem that our final comment would be to ‘watch this space’ as there are no doubt going to be further changes and discussions around finding the balance in this ongoing tug-of-war.

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