

S C H O O L O F  
ACCOUNTANCY

## University of the Witwatersrand

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

### A CRITICAL ANALYSIS OF THE TAXATION IMPLICATIONS OF CLAWBACK PROVISIONS ON EXECUTIVE PERFORMANCE INCENTIVE SCHEMES

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## 1. ABBREVIATIONS AND ACRONYMS

The following abbreviations and acronyms have been used throughout this research report with the meanings specified below:

### General

- 'CDP' – Cash and Deferred Plan
- 'CEO' – Chief Executive Officer
- 'CFO' – Chief Financial Officer
- 'CU' – Currency Units
- 'KPI' – Key Performance Indicators
- 'LTIP' – Long Term Incentive Plan
- 'SHARS' – Share Appreciation Rights
- 'STIP' – Short Term Incentive Plan

### South African Context

- 'BCEA' – Basic Conditions of Employment Act 71 of 1997
- 'BEE' – Black Economic Empowerment
- 'CGT' – Capital Gains Tax
- 'ITA' – Income tax Act 58 of 1962
- 'JSE' – Johannesburg Stock Exchange
- 'LRA' – Labour Relations Act 66 of 1995
- 'PAYE' – Pay As You Earn
- 'RLAA' – Revenue Laws Amendment Act 32 of 2004
- 'RLAB' – Explanatory Memorandum on the Revenue Laws Amendment Bill 2004
- 'SA' – South Africa
- 'SARS' – South African Revenue Service
- 'SDL' – Skills Development Levy
- 'TAA' – Tax Administration Act 28 of 2011
- 'UIF' – Unemployment Insurance Fund

USA Context

'CFR' – Code of Federal Regulations

'FICA' – Federal Insurance Contributions Act of 1954

'IRC'- Internal Revenue Code of 1986

'IRS' – Internal Revenue Service

'SEA' – Securities Exchange Act of 1934

'SEC' – Securities Exchange Commission

'SOX' – Sarbanes-Oxley Act of 2002

'TARP' – Troubled Asset Relief Program

'USA' – United States of America

## 2. ABSTRACT

Clawback provisions in executive performance incentive schemes serve as a risk management tool, and the use thereof by companies listed on the JSE has increased in recent years. In South Africa, the regulatory regimes have not been developed to address this. Through a comparative study with the USA, this research proposes a taxation framework that South Africa could adopt in regulating the clawback process with respect to cash and equity-based incentive awards. This research scrutinizes the existing definitions of s 8C, the concept of remuneration and the income tax implications of a clawback. Suggestions and recommendations are made for future reform.

Key words:

clawback, performance incentive scheme, income tax, remuneration, section 8C, Income Tax Act, listed, executive, risk management, regulatory, provision

### **3. CHAPTER ONE - INTRODUCTION**

Since the global financial crisis of 2008, exorbitant executive remuneration has been in the spotlight. The rise in corporate failures, both locally and abroad has cast doubt on the correlation between increased executive pay and uncontrolled risk taking in corporate institutions. Executives tend to make decisions that translate into short-term gains rather than considering the long-term performance of the company.<sup>1</sup>

One of the key responsibilities of senior executives as stipulated in the King IV report is to ensure 'accountability for organizational performance'.<sup>2</sup> This is achieved through strategy development and implementation, in addition to ethical risk and compliance management.<sup>3</sup> According to Steenkamp & Wesson,<sup>4</sup> a substantial component of executive remuneration comprises of performance incentives as this aims to streamline executive decisions with company strategy, whilst ensuring that executives act in the best interests of shareholders. This creates a problem, however, in that performance-based remuneration provides room for manipulation of results, gross misconduct, risk management oversight and poor performance.<sup>5</sup> As this has serious consequences for companies, regulatory structures have been introduced in certain jurisdictions to combat the adverse effects of irresponsible decision-making.<sup>6</sup> One such mechanism is the use of the clawback.

A clawback is a contractual provision that allows an employer to demand repayment of an incentive-based award granted to an employee in the case of poor performance, or any form of misconduct being identified.<sup>7</sup> Clawback provisions differ from malus (penalty) provisions in that the former are post-vesting events whilst the latter are pre-vesting.<sup>8</sup> Although both provisions serve as risk mitigation tools, clawback provisions are a corrective, disciplinary measure in response to unscrupulous conduct, while malus provisions are a pre-emptive measure that are

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<sup>1</sup> Madlela, 2018: 45

<sup>2</sup> IODSA, 2016: 21

<sup>3</sup> IODSA, 2016: 20-21

<sup>4</sup> Steenkamp & Wesson, 2018: 1-2

<sup>5</sup> PwC, 2015: 11

<sup>6</sup> Madlela, 2018: 46

<sup>7</sup> Kenton, 2019a

<sup>8</sup> Franklin, 2016

enforced prior to the payment of the incentive awards.<sup>9</sup> Clawbacks serve as an insurance mechanism and allow the employer to effectively manage bonuses and other share incentive awards granted to employees and senior executives.<sup>10</sup> Malus provisions are executed prior to the payment, whilst clawback provisions are executed subsequent to payment, thereby resulting in a reimbursement of amounts previously paid out.

According to Visser<sup>11</sup>, clawback provisions have been

‘... designed to deter executives from pursuing inappropriate strategies that would enable them to benefit from short-term increases in the company’s value, but which could potentially undermine the sustainability of the company in the long term.’

These provisions, once inserted into performance incentive schemes, allow the employer to recoup amounts paid to senior executives in the event of misconduct, fraud, or any other form of gross misrepresentation that had an adverse effect on the company’s performance or reputation.<sup>12</sup> As reported by the Corporate Finance Institute,<sup>13</sup> the inclusion of clawback provisions in remuneration schemes had a direct impact on investor confidence as this improved the credibility of financial statements. These provisions serve as a penal as well as remedial measure in preventing unethical business conduct from spiralling out of control.

### **3.1 SOUTH AFRICAN OVERVIEW**

In South Africa, the use of clawback provisions in executive remuneration is applied at the discretion of the employer, however, there has been an increasing trend over the past few years, particularly amongst listed entities to include these provisions as part of the remuneration plans. According to the FTSE Russell Factsheet on 31 January 2019,<sup>14</sup> 8 companies from the JSE’s top 10<sup>15</sup> were found to have clawback provisions included as part of executive remuneration. The

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<sup>9</sup> Franklin, 2016

<sup>10</sup> Kenton, 2019

<sup>11</sup> Visser, 2018

<sup>12</sup> Bussin & Christos, 2016: 37

<sup>13</sup> Corporate Finance Institute, n.d.

<sup>14</sup> FTSE Russell, 2019: 2

<sup>15</sup> The Standard Bank Group Limited and Absa Group Limited are the 2 companies in the JSE’s top 10 that do not have clawback included in the annual integrated reports.

treatment of clawback by these companies as reflected in the annual integrated reports are as follows:

1) Naspers Limited – Integrated Annual Report on 31 March 2019

'This year we introduced clawback provisions on the short-term and long-term incentives for the CEO and his direct reports. In the 2019 financial year, these clawback provisions were not invoked.'<sup>16</sup>

2) BHP Group Limited – Annual Report on 30 June 2019

'The CDP, LTIP and STIP rule provisions allow the Committee to reduce or clawback awards in the following circumstances:

- the participant acting fraudulently or dishonestly or being in material breach of their obligations to the Group;
- where BHP becomes aware of a material misstatement or omission in the Financial Statements of a Group company or the Group; or
- any circumstances occur that the Committee determines in good faith to have resulted in an unfair benefit to the participant.

These malus and clawback provisions apply whether or not awards are made in the form of cash or equity, whether or not the equity has vested, and whether or not employment is ongoing.'<sup>17</sup>

3) Richemont Limited – Annual Report on 31 March 2019

'In addition to applicable statutory provisions, the Group's long-term incentive plans include provisions allowing the Group to reclaim, in full or in part, distributed compensation as a result of special circumstances. Upon termination of employment as a result of serious misconduct, including fraud as defined by the applicable criminal law and violation of the Group's Standards of Business Conduct, all awards granted and outstanding, whether vested or unvested, lapse immediately without any compensation. In the event of termination of employment for another reason, other than retirement, death or disability, awards which are unvested at the date of termination of employment lapse immediately without any compensation.'<sup>18</sup>

4) Anglo American Limited – Annual Report on 31 December 2018<sup>19</sup>

'To help ensure sustainable long term performance, 60% of any annual bonus is deferred into shares for a minimum of three years and is subject to clawback. Vested LTIP awards are subject to clawback and must be held for an additional two years to encourage alignment of executive and shareholder interests.'<sup>20</sup>

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<sup>16</sup> Naspers, 2019: 67

<sup>17</sup> BHP Group, 2019: 146

<sup>18</sup> Richemont, 2019: 61

<sup>19</sup> The 2019 Annual Report is not available to date.

<sup>20</sup> Anglo American, 2018: 11

'Unvested Bonus Shares are subject to malus and clawback. Vesting based on TSR performance and achievement against a balanced scorecard of financial and strategic measures and subject to malus and clawback.'<sup>21</sup>

'The committee is able to reduce any unvested Bonus Share awards, or future awards, in the event of a material misstatement in the Group's results, misconduct or a material failing in risk management processes that has given, or is likely to give, rise to significant and lasting value destruction for the Group.'<sup>22</sup>

'The committee is able to reduce any unvested awards, vested awards subject to a holding period or future grants in the event of a material misstatement in the Company's results, misconduct or a material failing in risk management processes that has given, or is likely to give, rise to significant and lasting value destruction for the Company.'<sup>23</sup>

## 5) Sasol Limited – Integrated Report on 30 June 2019

'The Committee has again reviewed the Clawback policy and made some enhancements that will result in the policy being applied in a variety of situations. The Clawback policy has been extended to result in broader application to our Leadership role category (it was previously only applicable to our Group Executives and Senior Vice Presidents) and we included a malus clause. The Committee is satisfied that the policy aligns with the proposed Section 10D of the US Securities Exchange Act as well as the recommended practices in Principle 14 of King IV™.'<sup>24</sup>

'In respect of executive remuneration, we have seen a move toward simplification of reporting on remuneration. This has signalled an environment in which transparency features strongly via reporting mechanisms such as single figure disclosure, clawback and malus provisions, more focus on minimum shareholding requirements as well as a noticeable growth in shareholder activism (requiring increased shareholder engagement from organisations) and an enhanced focus on environmental issues.'<sup>25</sup>

## 6) FirstRand Group Limited – Annual Integrated Report on 30 June 2019

'Malus is applicable to awards that have not yet vested, and where required these will be cancelled.

Clawback applies once an award has vested, and an event occurs that triggers the repayment of the award.

If performance conditions are not satisfied, both short-term and long-term incentive allocations are forfeited. The committee has the discretion to claw back the pre-tax proceeds of any discretionary payment received by employees in the event of a trigger event as detailed below.

A trigger event may include, inter alia:

- the discovery of a material misstatement of performance that resulted in a variable reward made, which the board is satisfied that the employee has contributed to and is responsible for;
- the discovery that the assessment of any metrics upon which the award was made was based on erroneous, inaccurate or misleading information;
- any action or conduct which, in the reasonable opinion of the board, amounts to dishonesty, fraud or misconduct;
- the discovery of a material failure in risk management to which the employee had contributed and is responsible for; and/or

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<sup>21</sup> Anglo American, 2018: 102

<sup>22</sup> Anglo American, 2018: 104

<sup>23</sup> Anglo American, 2018: 105

<sup>24</sup> Sasol, 2019: 75

<sup>25</sup> Sasol, 2019: 76

- the discovery that performance related to financial and non-financial targets was misrepresented and that such misstatement led to the over-payment of incentives.

The clawback applies for three years after the discretionary payment is made, or in the case of share schemes (both LTIs and deferred STIs), three years after the awards have vested.<sup>26</sup>

### 7) MTN Limited – Annual Integrated Report on 31 December 2018<sup>27</sup>

'During 2018, the board approved the implementation of clawback and malus provisions effective for the December 2017 allocation.

#### Malus provisions

These provisions allow the board to reduce the number of MTN shares awarded to any participant under the PSP scheme in certain circumstances before the settlement of the underlying shares. The adjustment would notably apply where the relevant accounts for any company, business or undertaking where the participant worked or works, or for which he/she was or is directly or indirectly responsible, are found to be materially incorrect or require restatement.

#### Clawback provisions

These provisions would apply in respect of a period after the settlement of the underlying shares to the relevant participant and effectively provide MTN with a contractual right to recover an amount of money from a participant in certain similar circumstances as those that apply to the malus provisions, but which arise (or are only disclosed) after settlement.<sup>28</sup>

### 8) Sanlam Limited – Annual Integrated Report on 31 December 2018<sup>29</sup>

'Where defined trigger events take place, provision is made for redress against remuneration through either malus (pre-vesting forfeiture) or clawback (post-vesting forfeiture). Malus and clawback provisions and the application thereof to trigger events are governed by the Sanlam Group Malus and Clawback Policy, which is a related policy to this Group Remuneration Policy and these provisions will be incorporated in relevant remuneration governance documents/rules.<sup>30</sup>

## 3.2 RELEVANCE OF THE STUDY

Based on a general overview of the above extracts, companies in South Africa are effecting clawback and malus provisions either in part or in full when certain trigger events occur. Such events include serious misconduct, fraudulent or dishonest behaviour, material misstatements, misrepresentation or omission. Once employees leave the company, the legal route is followed to recover amounts previously paid out.

<sup>26</sup> FirstRand Group, 2019: 120

<sup>27</sup> The 2019 Annual Integrated Report is not available to date.

<sup>28</sup> MTN, 2018: 80

<sup>29</sup> The 2019 Annual Integrated Report is not available to date.

<sup>30</sup> Sanlam, 2018: 169

King IV report requires that executive compensation not only be linked to performance, but should also foster accountability and responsibility amongst executives.<sup>31</sup> In addition, remuneration policies should be aligned to 'international regulations and market practice'.<sup>32</sup> Discretion of the board and the remuneration committee is widely exercised in enforcing the clawback provisions, thereby creating inconsistency in application between companies. Moreover, the extracts above do not refer to legislation for a framework to be applied in enforcing the clawback. This loophole in the legislative environment with respect to clawback needs to be addressed from a legal, governance, accounting and taxation point of view so that a standardized approach can be developed. The taxation consequences thereof form the crux of this study.

### 3.3 EXISTING TAX TREATMENT IN SOUTH AFRICA

In South Africa at present, executive remuneration packages comprise of the basic salary, pension, performance-related incentive awards and other fringe benefits. For the purposes of this study, the taxation implications on the clawback of performance-related incentive awards will be the focal point. Performance-related incentive awards may be granted to executives in cash or through equity participation plans. The objective of these awards is to remunerate executives for the role played in creating shareholder value. This in turn translates into success of the company in both the short and long term.<sup>33</sup> Currently, the provisions of the Income Tax Act 58 of 1962 ('ITA') govern the taxation implications of cash and equity-based incentive awards up to the point of vesting. Subsequent to vesting, there is no definitive guidance on the manner in which to clawback amounts previously paid out.

With respect to equity awards, the current wording in s 8C distinguishes between restricted and unrestricted equity instruments.<sup>34</sup> Restricted equity instruments are subject to certain conditions, all of which need to be met before vesting occurs.<sup>35</sup> According SAIT<sup>36</sup>, the current wording in s 8C(7)(b)(ii)<sup>37</sup> of the definition of a restricted equity instrument creates contention in that the

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<sup>31</sup> IODSA, 2016: 31 and Schrage, 2012

<sup>32</sup> SARA and IODSA, 2017: 9

<sup>33</sup> PwC, 2018: 23

<sup>34</sup> ITA, 1962: s 8C(7)

<sup>35</sup> ITA, 1962: s 8C(3)

<sup>36</sup> SAIT, 2018: 5-7

<sup>37</sup> ITA, 1962: s 8C(7)(b)(ii)

categorization of a clawback provision as a restriction has an impact on the vesting date of the award. It may be problematic in certain cases, especially where all other restrictions for vesting have been met, except for the requirement that triggers the clawback of the shares. As such, vesting may be delayed. In terms of the definition of a clawback as stated by Franklin,<sup>38</sup> a clawback provision is a post-vesting event, not a pre-vesting event. Therefore, in substance, the inclusion of a clawback should not have an impact on the vesting date.

In addition to this, the occurrence of events requiring the enforcement of the clawback is uncertain. Until a trigger event occurs that requires the recoupment of the award, there may be no reason to enforce the clawback. This creates a problem for the executive as the recipient of the award, as they may be locked into an arrangement for many years that does not compensate them monetarily for the services rendered to the company. On the contrary, executives could choose to dispose of the equity award at an earlier point in time, which would trigger immediate vesting irrespective of any clawback provision being in place.<sup>39</sup>

In addition to this, performance incentive awards are regarded as remuneration and are taxed as such.<sup>40</sup> Revenue items are taxed at higher rates in comparison to capital items in South Africa.<sup>41</sup> The purpose of share incentive schemes is to remunerate senior executives for risks taken in steering the company in a way that will achieve optimal performance.<sup>42</sup> They also serve as a mechanism to attract and retain the correct talent so that a company can achieve its strategic objectives.<sup>43</sup> In substance therefore, executives obtain an interest in the company that inspires higher levels of efficiency and performance.<sup>44</sup> Foster<sup>45</sup> points out however that the existing taxation regime in South Africa does not correlate with this purpose. Taxing these awards as part of revenue discourages executives to perform optimally as there are few tax advantages available. From a risk-reward perspective as well, the existing tax consequences seem to deter investment in companies.<sup>46</sup>

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<sup>38</sup> Franklin, 2016

<sup>39</sup> SAIT, 2018: 5-7

<sup>40</sup> ITA, 1962: Fourth Schedule

<sup>41</sup> SARS, 2018a: 593

<sup>42</sup> Jensen & Murphy, 1990

<sup>43</sup> IODSA, 2016: 65

<sup>44</sup> Arendse, 2007: 14

<sup>45</sup> Foster, 2016: 26-27

<sup>46</sup> Foster, 2016: 26

### 3.4 USA OVERVIEW

According to Madlela,<sup>47</sup> remuneration policies in South Africa follow the lead set by the USA and UK. Moreover, policies on clawback thus far have only been mandated in the USA and the Netherlands.<sup>48</sup> In the USA particularly, legislation has been developed and implemented over the last decade since the global financial crisis. The Sarbanes-Oxley Act of 2002 ('SOX')<sup>49</sup> provides direction on the clawing back of compensation paid to senior executives.<sup>50</sup> Furthermore, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 addresses excess payments resulting from errors in financial performance measures.<sup>51</sup> The Internal Revenue Code of 1986 ('IRC') dealing with taxation was then amended to provide guidance on the appropriate tax treatment.

For the purposes of this study, the taxation implications of clawback provisions on companies and individuals resident in South Africa will be evaluated. Legislation in the USA will be used as the only comparative and recommendations will be drawn for South Africa in terms of enhancing the existing Income Tax law. As the USA was at the forefront of the global financial crisis, legislation in that jurisdiction was developed substantially to remediate the adverse effects of the various corporate scandals that occurred, whilst at the same time, to prevent the recurrence of such events in future. Through this comparative study with the USA, this research report seeks to identify a framework that could be adopted here in South Africa in an effort to regulate the manner in which clawbacks are effected.

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<sup>47</sup> Madlela, 2018: 46-47

<sup>48</sup> Madlela, 2018: 46

<sup>49</sup> SOX, 2002: s 34

<sup>50</sup> Schwartz, 2008: 2

<sup>51</sup> Fried & Shilon, 2011a: 722-723

## **3.5 THE RESEARCH PROBLEM**

### **3.5.1 The Statement of the Problem**

Executive accountability and responsibility in decision-making remains a key concern globally. Over the past few years, numerous corporate scandals have occurred, both locally and abroad. Exorbitant performance incentives offered to executives creates the temptation to manipulate results that may cause adverse financial and reputational consequences for companies. To combat this risk, companies are including clawback provisions in the performance incentive schemes offered to executives so that the company, in the case of fraud or misconduct being identified, may recoup the cash equivalent of these awards.

The use of clawback by listed companies in South Africa has increased over the past few years. Local legislation governs the tax treatment only up to the point of vesting. Subsequent to vesting, King IV allows the board of directors and the remuneration committee to exercise discretion in determining how to clawback amounts from executives. This leads to inconsistency in application between companies and creates the need to develop a set of guidelines that can be used in uniformity by all listed companies.

### **3.5.2 The Sub-problems**

- a) How does the existing legislative framework in South Africa account for cash and equity-based performance incentive awards, and the necessary clawback provisions from a taxation point of view?

This study will analyse existing tax law in South Africa (including the ITA and relevant Interpretation Notes, Binding Private Rulings and other reports issued by SARS) in an effort to determine the current taxation consequences of cash and equity-based performance incentive awards issued to executives. This study will highlight the principles

applicable in an effort to identify areas where further development may be necessary. The study will also analyse governance reports and other legislation where necessary as this has a direct impact on the tax treatment. These include the Companies Act 71 of 2008, King IV Report on Corporate Governance, Basic Conditions of Employment Act 71 of 1997 and the Labour Relations Act 66 of 1995.

- b) How does the USA account for cash and equity-based performance incentive awards and the related clawback provisions from a taxation point of view?

The USA is a global leader on remuneration policy and South Africa tends to follow suit. This study will analyse tax legislation in the USA to determine how it accounts for executive performance schemes and the necessary clawback provisions. This study will only focus on cash and equity-based performance incentives issued to executives. Relevant legislation and governance reports will be analysed such as the Sarbanes-Oxley Act of 2002, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Securities Exchange Act of 1934, other SEC reports where applicable, the Internal Revenue Code of 1986 and other revenue rulings issued by the Internal Revenue Service ('IRS').

This study will also be done as a high-level overview of the principles governing the taxation of cash and equity-based performance incentive awards. The regulatory regime in the USA will then be contrasted to South Africa's existing taxation regime so that areas of development may be identified and inferences may be drawn.

- c) What is the rationale behind the classification of cash and equity-based performance incentive awards as remuneration in South Africa?

The classification of executive performance incentive awards as remuneration remains a contentious issue, due to the adverse tax consequences resulting therefrom. This research seeks to explore the underlying reasons for this classification; and additionally, what the tax implications would be when clawing back amounts from remuneration. These

findings will be contrasted to the approach applied in the USA so that conclusions and recommendations can be made.

- d) Should a clawback on an equity instrument be classified as a restriction in terms of s 8C(7)(b)(ii)<sup>52</sup> or not, and what is the impact of this classification from a taxation point of view?

This study will scrutinize the definitions provided in s 8C(7)(b)(ii)<sup>53</sup> in an effort to determine the appropriateness thereof with respect to enforcing a clawback on an equity instrument. The approach applied in the USA will also be studied so that recommendations may be proposed for South Africa in resolving the problem posed by the current wording of s 8C(7)(b)(ii) of the ITA.

### **3.6 METHODOLOGY**

The study comprises solely of a literature review. This is an interpretive, qualitative study on the principles of taxation applied in South Africa and the USA. Information will be sourced in various ways including electronic databases (such as the internet), books, financial statements, conference papers, journals, magazine articles, statutes, reports, and other publications.

The comparison between taxation principles applied locally and in the USA will be illustrated by means of numerical examples. The purpose of this is to simplify the reader's understanding of the application of the necessary principles.

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<sup>52</sup> ITA, 1962: s 8C(7)(b)(ii)

<sup>53</sup> ITA, 1962: s 8C(7)(b)(ii)

### **3.7 SCOPE LIMITATIONS**

This study will only focus on the income tax consequences of executive performance incentive schemes on companies and individual taxpayers that are resident in South Africa. This study will only include cash and equity-based performance incentives.

The following aspects are excluded from the scope of this study:

- Section 8B Black Economic Empowerment schemes
- Seventh Schedule fringe benefits resulting from performance incentive awards
- Equity instruments held as trading stock
- Malus (pre-vesting) provisions

### **3.8 CHAPTER OUTLINE**

#### **Chapter One: Introduction**

This chapter provides background to the topic and introduces the various issues that will be studied. It highlights the importance and relevance of the study as well as the methodology to be used. Limitations to the scope of the study are also mentioned.

#### **Chapter Two: South African Tax Implications**

This chapter analyses the existing income tax legislation in South Africa, particularly with respect to cash and equity-based performance incentives awarded to executives. This is a high-level analysis on the principles applicable. Other relevant legislation and corporate governance reports are also reviewed to better understand the current regulatory impact of the enforceability of a clawback.

The components of remuneration and the rationale therefore is also evaluated so that the reasons for the classification of performance incentives as such can be determined. In addition to this, the definitions of s 8C are scrutinized to ascertain the impact of the current wording on a clawback of an equity award.

### **Chapter Three: USA Tax Implications**

This chapter follows the same approach as noted above in chapter 2, except that USA legislation will be used as a basis. The existing tax legislation, as well as corporate governance legislation and reports in the USA are analysed with respect to cash and equity-based performance incentives awarded to executives. A high-level overview on the applicable principles is provided.

The concept of remuneration and its components is also evaluated to better understand the classification and tax treatment thereof. The classification of clawbacks in USA tax law, particularly with respect to any restrictions that they may pose on the equity instrument is also discussed.

### **Chapter Four: Comparative Analysis**

Through various scenarios, this chapter compares and contrasts the taxation principles applicable in South Africa and the USA. Numerical examples are used to simplify the comparative process and to enhance the user's understanding of the tax implications in each country.

This chapter also provides insight on the reasons for performance incentive awards being classified as remuneration. Furthermore, it contrasts the approach adopted by South Africa and the USA with respect to the tax treatment of a clawback and the restrictions posed by the

definitions of s 8C(7)(b)(ii).<sup>54</sup> Key differences between the two regimes are noted and recommendations are made where necessary.

## **Chapter Five: Conclusion**

This chapter summarizes the findings from the aforementioned study. Inferences are drawn from existing practice in the USA and South Africa in an effort to highlight areas for improvement in South African tax law. Solutions are proposed on how to regulate the clawback process locally. In addition, insight is provided on the concept of remuneration and the reasoning behind performance incentives being classified as such. Suggestions and recommendations for further implementation are also provided.

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<sup>54</sup> ITA, 1962: s 8C(7)(b)(ii)

## **4. CHAPTER TWO – SOUTH AFRICAN TAX IMPLICATIONS**

Terms that are frequently used in this research report with respect to South African income tax are defined below. Where necessary, these definitions have been repeated in the discussion for ease of reference.

### **4.1 KEY DEFINITIONS**

According to s 1 of the ITA,<sup>55</sup> the following terms have been defined as follows:

‘Gross Income<sup>56</sup> –

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely –

...

- (c) any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount (other than an amount referred to in section 8 (1), 8B or 8C) received or accrued in respect of any employment or the holding of any office.

...’

‘Equity shares<sup>57</sup> –

Any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution’

According to s 8C(7) of the ITA,<sup>58</sup> equity instruments are defined as follows:

‘Equity Instruments<sup>59</sup> –

An equity instrument means a share or a member’s interest in a company, and includes -

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<sup>55</sup> ITA, 1962: s 1

<sup>56</sup> ITA, 1962: s 1

<sup>57</sup> ITA, 1962: s 1

<sup>58</sup> ITA, 1962: s 1

<sup>59</sup> ITA, 1962: s 8C(7)

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

From the above definitions, one can deduce that all amounts of a non-capital nature earned by a resident by virtue of employment are included in gross income. This includes cash and equity-based incentive awards. With respect to shares, equity shares are classified as equity instruments. Shares that carry a fixed right to dividends or repayment of capital such as preference shares; will not satisfy the definition of an equity instrument as illustrated above.<sup>60</sup>

## 4.2 BACKGROUND AND INTRODUCTION

Prior to 26 October 2004, s 8A<sup>61</sup> of the ITA applied to the gains made by directors or employees on the rights to acquire marketable securities. This section taxed the gains made by directors or employees on the exercise, release or cession of a marketable security, provided the right was acquired by virtue of employment. Section 8A(1)(b)<sup>62</sup> also provided the employee with the option to defer the gains made to a later year of assessment when the taxpayer becomes entitled to dispose of the marketable security.

As equity instruments were developing and becoming more complex, the need to revise the tax legislation arose. Consequently, the Revenue Laws Amendment Act 32 of 2004 ('RLAA') introduced s 8C into the Income Tax Act.<sup>63</sup> Section 8C seeks to tax as part of revenue, all gains and losses earned on equity instruments up to the point of vesting.<sup>64</sup> The equity instruments subject to s 8C need to have been acquired by employees or directors by virtue of employment after 26 October 2004. According to the Explanatory Memorandum to the Revenue Laws Amendment Bill,<sup>65</sup> s 8A was inadequate in accounting for the taxation consequences comprehensively as equity instruments were becoming more complex. With the introduction of

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<sup>60</sup> Du Plessis, 2005: 106

<sup>61</sup> ITA, 1962: s 8A

<sup>62</sup> ITA, 1962: s 8A(1)(b)

<sup>63</sup> RLAA, 2004: 12 and Butler, 2005:3

<sup>64</sup> Warneke & Jooste, 2010: 101

<sup>65</sup> RLAA, 2004b: 10

s 8C and in contrast to s 8A, losses have become deductible and further roll-over relief is provided for the exchange of restricted equity instruments.<sup>66</sup>

## 4.3 CURRENT TAX TREATMENT OF EQUITY-BASED PERFORMANCE INCENTIVES

### 4.3.1 Income Tax Treatment

Section 8C<sup>67</sup> is applicable upon the vesting of an equity instrument that was initially acquired by virtue of employment or the holding of the office of a director in the company, and has been defined as follows:

- '(1) (a) - Notwithstanding sections 9C and 23(m), a taxpayer must include in or deduct from his or her income for a year of assessment any gain or loss in respect of the vesting during that year of any equity instrument, if that equity instrument was acquired by that taxpayer -
- (i) by virtue of his or her employment or office of director of any company or from any person by arrangement with the taxpayer's employer;
  - (ii) by virtue of any restricted equity instrument held by that taxpayer in respect of which this section will apply upon vesting thereof; or
  - (iii) as a restricted equity instrument during the period of his or her employment by or office of director of any company from -
    - (aa) that company or any associated institution in relation to that company; or
    - (bb) any person employed by or that is a director of -
      - (A) that company; or
      - (B) any associated institution in relation to that company.'

Section 8C(7)<sup>68</sup> defines equity instruments very broadly and includes any options to acquire shares, financial instruments that are convertible into shares and any contractual rights or obligations, the value of which is determined with reference to shares.

'Equity instrument' means a share or a member's interest in a company, and includes -

- (a) an option to acquire such a share, part of a share or member's interest;
- (b) any financial instrument that is convertible to a share or member's interest; and

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<sup>66</sup> Warneke & Jooste, 2010: 103

<sup>67</sup> ITA, 1962: s 8C

<sup>68</sup> ITA, 1962: s 8C(7)

- (c) any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member's interest'

Furthermore, s 8C(7)<sup>69</sup> distinguishes between restricted and unrestricted equity instruments.

'Restricted equity instrument' in relation to a taxpayer means an equity instrument -

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

'Unrestricted equity instrument' means an equity instrument which is not a restricted equity instrument.'

According to the above extract, restricted equity instruments include certain criteria that prevent the taxpayer from freely disposing of the equity instrument until all conditions cease to exist. Unrestricted equity instruments on the other hand allow the taxpayer to dispose of the instrument at any time. Interpretation note 55<sup>70</sup> issued by SARS explains that this categorization determines the timing of the taxable event. Likewise, s 8C(3)<sup>71</sup> indicates that restricted equity instruments

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<sup>69</sup> ITA, 1962: s 8C(7)

<sup>70</sup> SARS, 2011: 2

<sup>71</sup> ITA, 1962: s 8C(3)

vest upon the termination of all conditions, whilst unrestricted equity instruments are deemed to vest upon acquisition of the equity instrument. Section 8C(3)<sup>72</sup> states:

'An equity instrument acquired by a taxpayer is deemed for the purposes of this section to vest in that taxpayer

- (a) in the case of the acquisition of an unrestricted equity instrument, at the time of that acquisition; or
- (b) in the case of the acquisition of a restricted equity instrument, at the earliest of -
  - (i) when all the restrictions, which result in that equity instrument being a restricted equity instrument, cease to have effect;
  - (ii) immediately before that taxpayer disposes of that restricted equity instrument, other than a disposal contemplated in subsection (4) or (5) (a), (b) or (c);
  - (iii) immediately after that equity instrument, which is an option contemplated in paragraph (a) of the definition of "equity instrument" or a financial instrument contemplated in paragraph (b) of that definition, terminates (otherwise than by the exercise or conversion of that equity instrument);
  - (iv) immediately before that taxpayer dies, if all the restrictions relating to that equity instrument are or may be lifted on or after death; and
  - (v) the time a disposal contemplated in subsection (2) (a) (i) or (b) (i) occurs.'

Interpretation Note 55<sup>73</sup> further explains that any gain or loss arising from the vesting of an equity instrument should be taxed as part of the income of the employee in the year of vesting. The amount included in income excludes any return in capital or dividends arising from the distribution of the equity instrument as stipulated in s 8C(1A)<sup>74</sup> which states:

'A taxpayer must include any amount received by or accrued to him or her during a year of assessment in respect of a restricted equity instrument in his or her income for that year of assessment if that amount does not constitute -

- (a) a return of capital or foreign return of capital by way of a distribution of a restricted equity instrument;
- (b) a dividend or foreign dividend in respect of that restricted equity instrument; or
- (c) an amount that must be taken into account in determining the gain or loss, in terms of this section, in respect of that restricted equity instrument.'

For restricted equity instruments, the taxation is calculated on the difference between the market value on the date of vesting and the consideration initially paid per s 8C(2)(a)(ii),<sup>75</sup> which states:

'(2) (a) - The gain to be included in the income of a taxpayer –

...

- (ii) in any other case, is the amount by which the market value of the equity instrument determined at the time that it vests in that taxpayer exceeds the sum of any consideration in respect of that equity instrument'

<sup>72</sup> ITA, 1962: s 8C(3)

<sup>73</sup> SARS, 2011: 1

<sup>74</sup> ITA, 1962: s 8C(1A)

<sup>75</sup> ITA, 1962: s 8C(2)(a)(ii) and SARS,2011: 4

For unrestricted equity instruments on the other hand, the taxation on such difference is due at the date of acquisition. In effect, this ensures that any imminent tax advantages that may be available to the taxpayer cease; and that any gains or losses arising from the vesting of the shares are taxed appropriately.<sup>76</sup>

According to Arendse,<sup>77</sup> the consideration paid excludes any form of service rendered or to be rendered in lieu of the equity instrument. The consideration also excludes the market value of the old equity instrument where one instrument is exchanged for another.<sup>78</sup> Deneys Reitz<sup>79</sup> adds that where an equity instrument is acquired in exchange for the disposal of another equity instrument that has already vested, s 8C does not apply.

In terms of the definition of a connected person in s 1 of ITA,<sup>80</sup> an employee and any connected person to the employee are both regarded as connected persons to the employer. According to Interpretation Note 55,<sup>81</sup> when an employee disposes of restricted equity instruments to a connected person, this is regarded as a non-event for vesting purposes as both parties are connected. On date of vesting per s 8C,<sup>82</sup> any gain made by the connected person is deemed to be made by the employee. The employee therefore includes a gain in income for an amount equal to the market value less the consideration initially paid. The employee is also liable for employees' tax on this amount. According to s 58(2)<sup>83</sup> where a person disposes of an equity instrument to a connected person at market value, or for an inadequate or excessive consideration, a deemed donation results at the time of vesting, however this aspect falls out of the scope of this research report.

Section 8C(5)(b)<sup>84</sup> further illustrates that where a connected person to the employee acquires an equity instrument directly from the employer, this acquisition is deemed to be made directly by the employee and upon disposal the same tax consequences as mentioned above would apply.

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<sup>76</sup> Deneys Reitz: 2004

<sup>77</sup> Arendse, 2007: 15

<sup>78</sup> SARS, 2011, 3-4

<sup>79</sup> Deneys Reitz: 2004

<sup>80</sup> ITA, 1962: s 1

<sup>81</sup> SARS, 2011: 6

<sup>82</sup> ITA, 1962: s 8C

<sup>83</sup> ITA, 1962: s 58(2)

<sup>84</sup> ITA, 1962: s 8C(5)(b) and SARS, 2011: 6

If an employer repurchases an equity instrument for an amount less than market value from the employee, and then subsequently disposes of the equity instrument, no gain is deemed to accrue to the employee in terms of s 8C(5)(c).<sup>85</sup>

In cases where the employer repurchases restricted equity instruments from an employee for an amount that exceeds the consideration initially paid for the equity instrument, this difference must be included in taxpayer's income per s 8C(2)(a)(i)(aa).<sup>86</sup>

If a taxpayer exchanges a restricted equity instrument for another and receives payment in a form other than a restricted equity instrument, the payment must be included in the income of the taxpayer in the year of exchange.<sup>87</sup> The date of exchange is regarded as a non-vesting event, and therefore no s 8C income tax consequences arise on this date. The new equity instrument is also deemed to be acquired by virtue of employment. Any consideration initially paid for equity instrument exchanged may only be deducted in the year of vesting. Any resultant gain or loss may be included or deducted from income accordingly per s 8C(4)(a) and (b).<sup>88</sup>

In the case of a secondment where a resident obtains restricted equity instruments by virtue of employment, and is then seconded abroad for a period before vesting occurs, the s 8C gains are regarded as having being earned evenly throughout the period.<sup>89</sup> As such, the portion of the gain relating to services rendered abroad qualifies for the s 10(1)(o)(ii)<sup>90</sup> exemption, and the portion relating to services rendered locally will be taxed appropriately. This exemption states the following:

'(1) - There shall be exempt from normal tax:

...

(o) any form of remuneration –

...

(ii) to the extent to which that remuneration does not exceed one million Rand in respect of a year of assessment and is received by or accrues to any employee during any year of assessment by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee,

<sup>85</sup> ITA, 1962: s 8C(5)(c) and SARS, 2011: 6

<sup>86</sup> ITA, 1962: s 8C(2)(a)(i)(aa) and SARS, 2011: 6

<sup>87</sup> SARS, 2011: 7-8

<sup>88</sup> ITA, 1962: s 8C(4)(a) and (b) and SARS, 2011: 7

<sup>89</sup> SARS, 2011: 9-10

<sup>90</sup> ITA, 1962: s 10(1)(o)(ii) and SARS, 2011: 9-10

emolument or allowance, including any amount referred to in paragraph (i) of the definition of gross income in section 1 or an amount referred to in section 8, 8B or 8C, in respect of services rendered outside the Republic by that employee for or on behalf of any employer, if that employee was outside the Republic (Date of commencement: 1 March, 2020) -

(aa) for a period or periods exceeding 183 full days in aggregate during any period of 12 months; and

(bb) for a continuous period exceeding 60 full days during that period of 12 months,

and those services were rendered during that period or periods ...'

Any losses incurred by taxpayer may be deducted from income subject to s 23(m) and s 9C.<sup>91</sup>

Section 9C is discussed in part 13.3 below, while s 23(m) states:

'Deductions not allowed in determination of taxable income - No deductions shall in any case be made in respect of the following matters, namely:

(m) - subject to paragraph (k), any expenditure, loss or allowance, contemplated in section 11, which relates to any employment of, or office held by, any person (other than an agent or representative whose remuneration is normally derived mainly in the form of commissions based on his or her sales or the turnover attributable to him or her) in respect of which he or she derives any remuneration, as defined in paragraph 1 of the Fourth Schedule, other than –

(i) any contributions to a pension fund, provident fund or retirement annuity fund as may be deducted from the income of that person in terms of section 11F;

(ii) any allowance or expense which may be deducted from the income of that person in terms of section 11 (c), (e), (f) or (j);

(iiA) any deduction which is allowable under section 11 (nA) or (nB); and

(iii) ... deleted by s. 56 (1) (c) of Act No. 31 of 2013 with effect from 1 March, 2015

(iv) any deduction which is allowable under section 11 (a) or (d) in respect of any rent of, cost of repairs of or expenses in connection with any dwelling house or domestic premises, to the extent that the deduction is not prohibited under paragraph (b)

Section 23(m) above disallows as a deduction from income any expenditure incurred by the employee in earning remuneration; except for the categories of expenditure that this provision goes on to enumerate. Cash and share incentive awards are regarded as remuneration as discussed in part 15 below, hence any expenditure incurred in relation to this is disallowed in terms of s 23(m). Any losses incurred on amounts deemed capital in nature per s 9C as detailed in part 13.3 are also disallowed from income.

<sup>91</sup> ITA, 1962: s 23(m) and s 9C and SARS, 2011: 7

### 4.3.2 Revenue vs Capital

Case law in South Africa (other than decisions of the Tax Court) lays down principles which, in accordance with the doctrine of precedent have binding authority or persuasive authority. According to the Tax Guide for Share Owners,<sup>92</sup> the intention of the taxpayer is the determining factor when deciding whether an amount should be classified as revenue or capital in nature. This guide states that if the shares were bought in order to earn dividend income, they are held on capital account, and if they are purchased for resale, then they are regarded as being revenue in nature.<sup>93</sup> In other words, if the taxpayer had a speculative intention, the amounts are deemed to be revenue in nature, and if the taxpayer had the intention of long-term capital appreciation, then the shares are classified as being capital in nature.<sup>94</sup> If however, the taxpayer had multiple intentions, the primary intention is informed by the main purpose for which the shares were acquired.<sup>95</sup>

Courts take cognizance of the primary purpose for which the shares were acquired as well as the secondary purpose. Where the primary purpose appears to be capital in nature, but the secondary purpose includes a profit-making intent, the courts may deem the entire transaction to be revenue in nature.<sup>96</sup> The frequency of the purchase and resale of shares also plays a major role in determining the underlying intention. Fouche<sup>97</sup> points out that if shares will only be disposed of due to an unforeseen future event, this indicates the intention to hold the shares for capital purposes.

The categorization of proceeds as capital in nature, rather than as revenue in nature has more favorable tax consequences for the taxpayer. Capital gains are taxed at a lower effective tax rate than ordinary income. Capital gains tax ('CGT') is currently levied at an effective rate of 18% for individuals and 22.4% for companies in South Africa, whereas normal tax is levied at 45% for individuals and 28% for companies.<sup>98</sup> Furthermore, s 102<sup>99</sup> of the Tax Administration Act 28 of

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<sup>92</sup> SARS, 2018b: 3

<sup>93</sup> SARS, 2018b: 3

<sup>94</sup> BDO, 2014

<sup>95</sup> SARS, 2018b: 4

<sup>96</sup> SARS, 2018b: 4

<sup>97</sup> Fouche, 2011: 53

<sup>98</sup> SARS, 2018a: 593

<sup>99</sup> TAA, 2011: s 102

2011 ('TAA') also specifies that the burden of proof rests on the taxpayer to show that an amount should not be taxed, or if it should be taxed at a lower rate. Section 102<sup>100</sup> of TAA states the following:

- (1) A taxpayer bears the burden of proving:
- (a) that an amount, transaction, event or item is exempt or otherwise not taxable;
  - (b) that an amount or item is deductible or may be set-off;
  - (c) the rate of tax applicable to a transaction, event, item or class of taxpayer;
  - (d) that an amount qualifies as a reduction of tax payable;
  - (e) that a valuation is correct; or
  - (f) whether a 'decision' that is subject to objection and appeal under a tax Act, is incorrect.'

### 4.3.3 CGT Implications

Section 9C<sup>101</sup> of the ITA states:

'Circumstances in which certain amounts received or accrued from disposal of shares are deemed to be of a capital nature:

...

- (5) - There shall in the year of assessment in which any equity share held for a period of at least three years is disposed of by the taxpayer be included in the taxpayer's income any expenditure or losses incurred in respect of such equity share and allowed as a deduction from the income of the taxpayer during that or any previous year of assessment in terms of section 11: Provided that this subsection must not apply -

- (a) in respect of any expenditure or loss to the extent that the amount of that expenditure or loss is taken into account in terms of section 8 (4) (a) or section 19

...'

Section 9C deems certain amounts received or accrued from the disposal of shares to be capital in nature. According to the extract above, the proceeds on disposal of an equity share are deemed to be capital in nature if the share was held by the taxpayer for a minimum period of 3 years prior to disposal. CGT would therefore apply to the proceeds on disposal. If the taxpayer holds shares subsequent to the vesting date and then disposes of the shares, provided a minimum 3-year holding period has lapsed, s 9C would apply to the portion of the gains or losses that were not taxed in terms of s 8C on the vesting date.<sup>102</sup>

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<sup>100</sup> TAA, 2011: s 102

<sup>101</sup> ITA, 1962: s 9C

<sup>102</sup> BDO, 2014 and SARS, 2014: 32

It should be noted however, that in cases where the equity shares are disposed of before a 3-year period has lapsed, s 9C does not apply. Therefore, any changes in the market value would be taxed as part of gross income.<sup>103</sup> On the contrary, if the vesting period exceeds 3 years, the taxpayer cannot find relief in s 9C (deeming proceeds to be capital in nature) as s 8C (gains and losses are revenue in nature) would apply instead.<sup>104</sup> Section 8C which applies to all equity instruments therefore takes priority over the provisions of s 9C<sup>105</sup> of the ITA.

When the shares that are held on capital account and are eventually sold, CGT is levied on the proceeds less base cost of the asset on the date of disposal. With regard to proceeds, p 35(3)(a)<sup>106</sup> of the Eighth Schedule indicates the following:

'(3) - The proceeds from the disposal, during a year of assessment, of an asset by a person, as contemplated in subparagraph (1) must be reduced by -

(a) any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain

...'

Therefore, all amounts included in the gross income of a taxpayer should be excluded from proceeds in the calculation of CGT. Likewise, any expenditure deductible from gross income is excluded from the base cost of an asset per p 20(3)(a).<sup>107</sup>

'(3) - The expenditure incurred by a person in respect of an asset must be reduced by any amount which -

(a) (i) is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person; and

(ii) is not included in the taxable income of that person in terms of section 9C (5),  
before the inclusion of any taxable capital gain

...'

At the time of vesting of an equity instrument, the s 8C gains or losses are included in gross income. As such, these gains or losses will have no subsequent impact on CGT.

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<sup>103</sup> BDO, 2014

<sup>104</sup> BDO, 2014 and SARS, 2014: 32

<sup>105</sup> ITA, 1962: s 9C

<sup>106</sup> ITA, 1962: Eighth Schedule p 35(3)(a)

<sup>107</sup> ITA, 1962: p 20(3)(a)

With regard to equity instruments, p 20(1)(h)<sup>108</sup> of the Eighth Schedule states:

'20 (1) - ...the base cost of an asset acquired by a person is the sum of -

...  
(h) in the case of –

- (i) a marketable security or an equity instrument, the acquisition or vesting, as the case may be, of which resulted in the determination of any gain or loss to be included in or deducted from any person's income in terms of section 8A or 8C, the market value of that marketable security or equity instrument or amount received or accrued from the disposal thereof, as the case may be, that was taken into account in determining the amount of that gain or loss (including where the gain and loss so determined was nil)

...'

This extract illustrates that the market value of the equity instrument initially used to calculate the s 8C gain or loss is to be included in the base cost of the equity instrument on the date of disposal. This, in substance reduces the CGT payable and prevents double taxation on the same amount.<sup>109</sup>

When a taxpayer ceases to be a resident, a deemed disposal for CGT purposes occurs at market value on all worldwide assets with the exception of immovable property situated in South Africa.<sup>110</sup> In the case where a taxpayer held s 8C restricted equity instruments and ceased residency prior to vesting, the withdrawal of the employee from the company may trigger immediate vesting and income tax consequences will arise. If the employee transfers abroad and retains equity instruments that have not yet vested, s 8C income tax consequences would arise on the vesting date. This is because South Africa has a residence-based tax regime, and as such, non-residents are only taxed on income sourced in the Republic.<sup>111</sup> If however, the equity instruments have vested and were subsequently held on capital account by the employee, then upon the cession of residency, CGT becomes due. The CGT payable is calculated using the principles illustrated above.

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<sup>108</sup> ITA, 1962: p 20(1)(h)

<sup>109</sup> BDO, 2014 and SARS, 2014: 32

<sup>110</sup> Hughes & Crocker, 2018

<sup>111</sup> SARS, 2018c

#### 4.3.4 Options to Acquire Equity Instruments

Warneke & Jooste<sup>112</sup> explain that s 8C regards the options and the shares as two separate equity instruments. Where an option is exercised to acquire a restricted equity instrument, it is regarded as a restricted equity instrument per s 8C(7)(d)<sup>113</sup> of the definition of a restricted equity instrument. This section states the following:

‘Restricted equity instrument’ in relation to a taxpayer means an equity instrument –

...

(d) which is an option contemplated in paragraph (a) of the definition of “equity instrument” and where the equity instrument which can be acquired in terms of that option will be a restricted equity instrument

...’

Conversely, where an option is exercised to acquire an unrestricted equity instrument, then the option is regarded as an unrestricted equity instrument.

Where a restricted equity instrument is acquired by virtue of the exercise of an option, the exercise of the option does not constitute a vesting event per s 8C(3)(b)(iii)<sup>114</sup> which states:

‘An equity instrument acquired by a taxpayer is deemed for the purposes of this section to vest in that taxpayer

...

(b) in the case of the acquisition of a restricted equity instrument, at the earliest of -

(iii) immediately after that equity instrument, which is an option contemplated in paragraph (a) of the definition of “equity instrument” or a financial instrument contemplated in paragraph (b) of that definition, terminates (otherwise than by the exercise or conversion of that equity instrument)

...’

This section deems vesting to occur immediately once an option terminates, however the termination of the option should not be due to exercise or conversion. As such, any consideration paid for the option is not deducted from income on the date of exercise according to s 8C(2)(a) and (b).<sup>115</sup>

(2) (a) The gain to be included in the income of a taxpayer –

...

(ii) in any other case, is the amount by which the market value of the equity instrument determined at

<sup>112</sup> Warneke & Jooste, 2010: 109

<sup>113</sup> ITA, 1962: s 8C(7)(d)

<sup>114</sup> ITA, 1962: s 8C(3)(b)(iii)

<sup>115</sup> ITA, 1962: s 8C(2)(a) and (b)

the time that it vests in that taxpayer exceeds the sum of any consideration in respect of that equity instrument.

...

(b) The loss to be deducted from the income of a taxpayer –

...

(ii) in any other case, is the amount by which the consideration in respect of the equity instrument exceeds the market value of that equity instrument determined at the time that it vests in that taxpayer.’

Neither is the difference in market value and consideration paid included in income on exercise date. The s 8C gains or losses in this case are only triggered upon the vesting of the actual shares.<sup>116</sup>

In cases where an option is exercised for the acquisition of shares, p 20(1)(c)(ix)<sup>117</sup> of the Eighth Schedule includes the cost initially paid for this option in the base cost when determining the capital gain or loss. This paragraph is included below:

‘20 (1) - ... the base cost of an asset acquired by a person is the sum of -

...

(c) the following amounts actually incurred as expenditure directly related to the acquisition or disposal of that asset namely –

...

(ix) if that asset was acquired or disposed of by the exercise of an option (other than the exercise of an option contemplated in item (f)), the expenditure actually incurred in respect of the acquisition of the option

...’

If any such amounts were initially allowed as a deduction from income per s 11(a),<sup>118</sup> these would be excluded from the base cost according to p 20(3)(a).<sup>119</sup>

Had there been no restriction on the holding period of the shares, the employee would have been able to dispose of the shares at any time. These shares would represent unrestricted equity instruments, and any option to acquire these instruments would also be classified as an

<sup>116</sup> Warneke & Jooste, 2010: 109

<sup>117</sup> ITA, 1962: p 20(1)(c)(ix) and SARS, 2018a: 194

<sup>118</sup> ITA, 1962: s 11(a)

<sup>119</sup> ITA, 1962: Eighth Schedule - p 20(3)(a) and SARS, 2018a: 198

unrestricted instrument.<sup>120</sup> In terms of s 8C(3)(a),<sup>121</sup> the vesting of an unrestricted equity instrument occurs at the time of acquisition of the instrument.

'An equity instrument acquired by a taxpayer is deemed for the purposes of this section to vest in that taxpayer

(a) in the case of the acquisition of an unrestricted equity instrument, at the time of that acquisition

...'

All applicable gains or losses are therefore taxed on this date. Subsequently, in terms of s 8C(1)(b)(i),<sup>122</sup> there are no further tax implications after vesting, except for CGT, which will be triggered upon the disposal of the shares, provided they were held for capital appreciation purposes.<sup>123</sup> Section 8C(1)(b)(i)<sup>124</sup> is included below:

'S 8C - Taxation of directors and employees on vesting of equity instruments –

...

(1) (b) This section does not apply in respect of any equity instrument which –

(i) was acquired by the exercise or conversion of, or in exchange for the disposal of, any other equity instrument where this section applied in respect of the vesting of that other equity instrument before that exercise, conversion or exchange; or

...'

The base cost of unrestricted equity instruments, initially acquired through the exercise of an option, includes the all expenditure incurred with respect to the acquisition of the option per p 20(1)(c)(ix),<sup>125</sup> as well as the market value of the equity instrument on the date the s 8C gain or loss was calculated per p 20(1)(h)(i).<sup>126</sup>

When an option or financial instrument is disposed of through release, abandonment or lapse, the excess of amount received or accrued over consideration initially paid is included in the income of taxpayer in accordance with s 8C(2)(a)(i)(bb).<sup>127</sup>

<sup>120</sup> Warneke & Jooste, 2010: 112

<sup>121</sup> ITA, 1962: s 8C(3)(a)

<sup>122</sup> ITA, 1962: s 8C(1)(b)(i)

<sup>123</sup> Bezuidenhout, 2006: 56 and Warneke & Jooste, 2010: 112

<sup>124</sup> ITA, 1962: s 8C(1)(b)(i)

<sup>125</sup> ITA, 1962: p 20(1)(c)(ix). Extract included above.

<sup>126</sup> ITA, 1962: p 20(1)(h)(i). Extract included above.

<sup>127</sup> ITA, 1962: s 8C(2)(a)(i)(bb) and SARS, 2011: 6

#### 4.4 CURRENT TAX TREATMENT OF CASH-BASED PERFORMANCE INCENTIVES

Cash-based performance incentives are paid out in the form of bonuses and are also included in the definition of remuneration.<sup>128</sup> As such, employees' tax will be deducted or withheld by the employer on such amounts paid to the employee. Cash bonuses are also included in the gross income of the employee as an amount received or accrued in respect of services rendered due to employment. As mentioned above, s 11(a)<sup>129</sup> allows for any expenditure or losses incurred in the production of income to be deducted from taxable income. Section 23(g)<sup>130</sup> then limits deductions that are allowed from income as follows:

'No deductions shall in any case be made in respect of the following matters, namely –

- ...  
 (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;

...'

This section specifies that deductions from income are only applicable to amounts actually incurred in the course of trade, i.e. any amount that is capital in nature does not qualify for this deduction.<sup>131</sup> Section 23H<sup>132</sup> also limits deductions from income to amounts actually incurred during the year of assessment.

'(1) - Where any person has during any year of assessment actually incurred any expenditure (other than expenditure incurred in respect of the acquisition of any trading stock) -

- (a) which is allowable as a deduction in terms of the provisions of section 11 (a), (c), (d) or (w), or section 11A; and

(b) in respect of -

- (i) goods or services, all of which will not be supplied or rendered to such person, during such year of assessment; or  
 (ii) any other benefit, the period to which the expenditure relates extends beyond such year of assessment,

the amount of the expenditure in respect of which a deduction shall be allowable in terms of such section in the said year and any subsequent year of assessment, shall be limited to, in the case of expenditure incurred in respect of –

- (i) goods to be supplied, so much of the expenditure as relates to the goods actually supplied to such person in such year of assessment; or  
 (ii) services to be rendered, an amount which bears to the total amount of such expenditure the same ratio as the number of months in such year during which such services are rendered bears to the total number of months during which such services will be rendered or, where the period

<sup>128</sup> ITA, 1962: Fourth Schedule. Extract included above.

<sup>129</sup> ITA, 1962: s 11(a)

<sup>130</sup> ITA, 1962: s 23(g)

<sup>131</sup> SARS, 2008: 4

<sup>132</sup> ITA, 1962: s 23H

- during which such services will be rendered is not determinable, such period during which the services are likely to be rendered; or
- (iii) any other benefit to which such expenditure relates, an amount which bears to the total amount of such expenditure the same ratio as the number of months in such year during which such person will enjoy such benefit bears to the total number of months during which such person will enjoy such benefit or where the period of such benefit is not determinable, such period over which the benefit is likely to be enjoyed:
- ...'

Where expenditure or benefits are paid in advance, s 23H above states that the deduction allowable per s 11(a) should be pro-rated to represent the period during the current year of assessment in which the taxpayer actually incurred the expense or rendered the services resulting in the enjoyment of the benefit.

Section 11(nA)<sup>133</sup> allows for any portion of a voluntary award received or accrued to an employee in lieu of services rendered to be deducted from taxable income of the employee if that amount was reimbursed to the employer.

'(nA) - so much of any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount received or accrued in respect of or by virtue of any employment or the holding of any office as was included in the taxable income of that person and is refunded by that person;

...'

By inference, this means that employees who receive cash bonuses include the amounts in gross income, and they qualify for s11 deductions where applicable. In the case where these voluntary awards are clawed back by the employer in the same year of assessment, the employee can claim a s 11(nA) deduction on the amounts repaid. This would reduce the employee's income tax obligation on the portion of the award that it does not actually receive.

According to Cridlan et al.<sup>134</sup>, share appreciation rights ('SHARS') are commonly used in South Africa. The value of these rights is determined with respect to the underlying shares, and upon vesting, the cash equivalent is paid out. The income tax treatment thereof is the same as for ordinary cash bonuses discussed above.

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<sup>133</sup> ITA, 1962: s 11(nA)

<sup>134</sup> Cridlan et al., 2017

#### 4.5 CLASSIFICATION OF PERFORMANCE INCENTIVE AWARDS AS REMUNERATION

Remuneration has been defined in the Fourth Schedule of the ITA<sup>135</sup> as follows:

'Remuneration' means any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered, including –

...  
(e) any amount referred to in section 8C which is required to be included in the income of that person;

...'

According to Interpretation Note 55, the classification of incentive bonuses and share awards as part of remuneration and the tax treatment thereof seeks to 'preserve ordinary treatment for growth-related salary as opposed to artificial characterization as capital'.<sup>136</sup> Foster<sup>137</sup> adds that from a taxation point of view however, this approach does not support responsible 'risk-taking' in businesses. On the one hand, executives are pressured to promote business growth through the adoption of strategies that translate into revenue, but on the other hand, the incentives paid out to these individuals in lieu of this service have more unfavorable tax consequences. As mentioned above, the capital gains are taxed at a lower effective rate than revenue.<sup>138</sup>

Foster<sup>139</sup> also indicates that this is particularly problematic in practice where executives are required to invest their personal funds together with other investors in a pool that is subject to a shareholder agreement. This arrangement is commonly used in private companies as a liquidity management tool so that immediate cash is available when required. From a taxation perspective however, the terms of the shareholder agreement qualify as restrictions per s 8C, and therefore upon vesting, the gains are taxed as revenue earned by virtue of employment, whilst outside shareholders are levied CGT. The tax implications in such an arrangement therefore do not promote share investing.<sup>140</sup>

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<sup>135</sup> ITA, 1962: Fourth Schedule

<sup>136</sup> SARS, 2011: 10

<sup>137</sup> Foster, 2016: 26

<sup>138</sup> SARS, 2018a: 593

<sup>139</sup> Foster, 2016: 26

<sup>140</sup> Foster, 2016: 26

The Explanatory Memorandum to the Revenue Laws Amendment Bill<sup>141</sup> argues that executive share schemes generally tend to be advantageous to the taxpayer, whilst being in conflict with the principle of vertical equity. Kagan<sup>142</sup> explains that vertical equity is a method applied by the fiscus with respect to income tax collection, in which higher income earners are subjected to higher income tax. This tenet conforms to the 'ability to pay' principle which states that the amount of tax an individual is liable for should be based on the wealth of the individual and the burden that such taxes will have on this wealth.<sup>143</sup> When equity-based incentives are awarded to executives, greater tax advantages are afforded to them when compared to lower level employees who are subject to tax on their cash salaries.<sup>144</sup> As such, the classification of such awards as remuneration seeks to level the playing fields between higher and lower income earners.

Warneke & Jooste<sup>145</sup> point out that the taxation treatment of equity instruments is quite closely aligned to that of share appreciation rights. With share appreciation rights, employees or directors receive a cash lump sum periodically as the value of the underlying shares in the employer increase. If share prices fall during a particular year, no cash equivalent is paid out. Therefore, the employee's right to receive the cash is dependent on the underlying performance of the company's shares. These cash awards will therefore only be included in gross income once the amounts are received by or accrue to the taxpayer.<sup>146</sup> These cash awards also satisfy the definition of remuneration in the Fourth Schedule and therefore would be subjected to employees' tax. Likewise, the tax treatment of incentive-based equity instruments should be akin to this.

Currently s 8C seeks to tax as part of revenue any appreciation in the value of shares between acquisition date and vesting date. This is beneficial to the fiscus as revenue rates are currently higher than capital rates.<sup>147</sup> As with cash awards, these equity instruments are only granted to employees in lieu of services rendered, be it past, present or future services. As the payment for services is classified as remuneration, the equity awards granted should also be accounted for as such. Once all restrictions on the equity instruments cease to exist and the taxpayer becomes

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<sup>141</sup> RLAB, 2004b: 10

<sup>142</sup> Kagan, 2018

<sup>143</sup> Kenton, 2018

<sup>144</sup> SARS, 2004: 10

<sup>145</sup> Warneke & Jooste, 2010: 114

<sup>146</sup> Warneke & Jooste, 2010: 111

<sup>147</sup> SARS, 2018a: 593

unconditionally entitled to dispose of the instrument, then the income and remuneration tax consequences would cease, and instead capital gains tax consequences arise.<sup>148</sup>

On the contrary, PwC<sup>149</sup> has found that whilst bridging the wage gap in companies is a key priority, a reduction in executive pay is not a feasible solution, as this could trigger a mass exodus of executive talent from South Africa. In a study conducted, it was found that many companies try to bridge this gap by lowering the average salary increase rates for executives, whilst augmenting the annual increase rates for lower-level staff. This approach ensured staff retention while at the same time aligned salary scales to acceptable standards in the market.

#### 4.5.1 Employees' Tax Treatment

Paragraph 11A(1)(c)<sup>150</sup> of the Fourth Schedule states:

'11A (1) - ... the remuneration of an employee includes –  
 ...  
 (c) any amount referred to in section 8C which is required to be included in the income of that employee;  
 or  
 ...'

According to the above extract, remuneration includes any s 8C gain made upon the vesting of an equity instrument; hence, employees' tax becomes due. Employees' tax must be deducted or withheld by the employer from any consideration or remuneration paid to the employee with respect to the vesting of the equity instrument.<sup>151</sup> If a company is an associated institution to the employer company and grants restricted equity instruments to the employee, upon vesting both companies are jointly and severally liable to withhold or deduct the employees' tax on any s 8C gains made by the employee.<sup>152</sup>

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<sup>148</sup> Warneke & Jooste, 2010: 115

<sup>149</sup> PwC, 2015: 12

<sup>150</sup> ITA, 1962: p 11A(1)(c)

<sup>151</sup> SARS, 2011: 8

<sup>152</sup> SARS, 2011: 9

Additionally, where an employer repurchases equity shares from an employee for an amount less than market value as part of a restriction imposed on the equity shares, any amount paid to the employee less the consideration initially paid to the employee is deemed to be remuneration and employees' tax should be withheld or deducted accordingly.<sup>153</sup>

Under s 11(IA)<sup>154</sup> of the ITA, the employer qualifies for a deduction on the net of the market value of equity shares granted in terms of s 8B BEE share schemes and consideration paid by the employee. In addition to this, s 11(a)<sup>155</sup> allows as a general deduction expenditure and losses incurred in the ordinary course of trade that are not of a capital nature. Both sections are included for ease of reference below:

'Section 11 - For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived -

- (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature

...'

'(IA) an amount equal to the market value of any qualifying equity share granted to an employee of that person as contemplated in section 8B, as determined on the date of grant as defined in that section less any consideration given by that employee for that qualifying equity share, which applies *in lieu* of any other deduction which may otherwise be allowed to that person or any other person in respect of the granting of that share...'

Section 11 above does not specify whether employers can claim a deduction for the share awards granted in terms of s 8C. Bezuidenhout<sup>156</sup> points out that where share awards are issued with the intention to attract or retain staff as part of the managing the operational affairs of a business, many countries abroad allow employers the deduction of this expense from gross income. The employees are taxed upon receipt of such amounts, as part of remuneration. Local case law has shown that where a taxpayer has incurred an 'unconditional legal obligation' with respect to an amount incurred, then it would qualify for deduction under s 11(a).<sup>157</sup> Pertaining to s 8C share awards, the taxation implications are triggered upon vesting when the employee has an

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<sup>153</sup> SARS, 2011: 10

<sup>154</sup> ITA, 1962: s 11(IA)

<sup>155</sup> ITA, 1962: s 11(a)

<sup>156</sup> Bezuidenhout, 2006: 80

<sup>157</sup> Bezuidenhout, 2006: 78-79

unconditional right to receive the amounts. By inference, the employer would then have an unconditional obligation to settle the amount. In line with this, the employer granting the awards should receive a deduction corresponding to the employee's gross income inclusion on the vesting date.

The definition of remuneration in the Fourth Schedule includes all s 8C gains, on which employees' tax must be deducted or withheld. This amount is calculated from any monetary consideration payable to the employee; or from any consideration payable in relation to the disposal, release or cession of the equity instruments.<sup>158</sup> According to p 11A(5)<sup>159</sup> of the Fourth Schedule, if the amount of employees' tax payable exceeds the consideration paid to the employee, then the Commissioner should be notified so that alternate arrangements can be made. The granting of s 8C equity instruments to employees is not regarded as a deemed disposal, hence no CGT consequences arise for the employer.<sup>160</sup>

For employees, the amount of any voluntary award or shares received from the employer are included in gross income.<sup>161</sup>

Section 10(1)(nD)<sup>162</sup> then exempts from income any amount constituting a s 8C equity instrument or any consideration for the disposal of an equity instrument that had not yet vested.

'10 (1) There shall be exempt from normal tax –

...  
(nD) any amount received by or accrued to that person which constitutes -

- (i) an equity instrument contemplated in section 8C acquired by that person and in respect of which that section applies; or
  - (ii) consideration for the disposal of an equity instrument,
- which had not yet vested as contemplated in that section at the time of that acquisition or disposal;

...'

<sup>158</sup> Bezuidenhout, 2006: 64 and ITA, 1962: Fourth Schedule - p 11A(2)(a)

<sup>159</sup> ITA, 1962: Fourth Schedule - p 11A(5)

<sup>160</sup> Bezuidenhout, 2006: 63-64

<sup>161</sup> ITA, 1962: s 1

<sup>162</sup> ITA, 1962: s 10(1)(nD)

The employee is also obliged to inform the employer about any gains made on the disposal of equity instruments in accordance with p 11A(6).<sup>163</sup>

Furthermore, each month employers are obliged to pay a Skills Development Levy ('SDL') to SARS amounting to 1% of the total remuneration paid to employees, provided the total remuneration paid out to employees exceeds R500 000 within a 12-month period.<sup>164</sup> The purpose of SDL is to facilitate empowerment of employees through learning and skills development. The employer and employee are also each required to make a 1% contribution to the Unemployment Insurance Fund ('UIF'). This fund provides short-term monetary relief to employees in the case of unemployment. The employees' contribution is to be withheld by the employer and paid directly to SARS monthly.<sup>165</sup>

#### 4.6 IMPACT OF SECTION 8C DEFINITIONS ON A CLAWBACK

Currently, within the ambit of the existing ITA, clawbacks fall within the definition of a restricted equity instrument per s 8C(7).<sup>166</sup> A restricted equity instrument is defined as:

'A restricted equity instrument in relation to a taxpayer means an equity instrument -

- (a) which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;
- (b) which is subject to any restriction that could result in the taxpayer -
  - (i) forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or
  - (ii) being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;

...'

According to paragraph 'b' above, the action of clawing back an award results in the employee either forfeiting the ownership rights to the underlying shares, or alternatively being 'penalized financially' through the repayment of the cash equivalent.

<sup>163</sup> ITA, 1962: p 11A(6) and Bezuidenhout, 2006: 65-66

<sup>164</sup> SARS, 2017

<sup>165</sup> SARS, 2019a

<sup>166</sup> ITA, 1962: s 8C(7)

According to Visser<sup>167</sup> and SAIT,<sup>168</sup> if clawback provisions are classified as ‘restricted’ equity instruments, they could have ‘impractical, unbusinesslike or oppressive’ consequences. This is evident where a taxpayer disposes of a restricted equity instrument and pays the necessary tax upon vesting according to s 8C. When a clawback provision exists in the agreement, this imposes a further restriction on the equity instrument. In accordance with the existing law, any subsequent value in the shares may be subject to income tax in terms of s 8C, but the value of these shares does not actually accrue to the taxpayer.<sup>169</sup> Consequently, the categorization of the clawback as a ‘restriction’ automatically makes employee liable to income tax twice on the same shares.<sup>170</sup> On the contrary, the existing law does not allow for the clawback provisions to be classified as unrestricted, as this would allow the taxpayer to freely dispose of the instrument without any further tax implications.<sup>171</sup>

In addition, King IV does not provide technical detail on strategies that companies should apply in effectively managing remuneration or clawbacks on incentive awards. This is left to the discretion of the remuneration committees and the board.<sup>172</sup> The Guide to the Application of King IV does however state that enforcement of clawback provisions should conform to international practice<sup>173</sup> and that upon execution, all necessary facts need to be disclosed.<sup>174</sup> It also emphasizes the need to disclose unvested awards so that stakeholders are notified of any potential liabilities that are conditional on performance.<sup>175</sup>

## 4.7 CORPORATE GOVERNANCE CONSIDERATIONS

According to Schrage,<sup>176</sup> the use of clawbacks in performance incentive schemes is important for managing ‘long-term business health against short-term bonus wealth’. Ethical business conduct and the alignment of an organization’s strategic interests to that of shareholder expectations forms

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<sup>167</sup> Visser, 2018

<sup>168</sup> SAIT, 2018: 6

<sup>169</sup> Visser, 2018

<sup>170</sup> SAIT, 2018: 6-7

<sup>171</sup> ITA, 1962: s 8C(7)

<sup>172</sup> IODSA, 2016: 66-67

<sup>173</sup> SARA & IODSA, 2017: 9

<sup>174</sup> SARA & IODSA, 2017: 22

<sup>175</sup> SARA & IODSA, 2017: 23-24

<sup>176</sup> Schrage, 2012

a keystone in King IV.<sup>177</sup> As part of being a good corporate citizen, companies need to fulfil rights, obligations and responsibilities owing to fellow stakeholders, investors and the public at large.<sup>178</sup> Section 7 of the Companies Act 71 of 2008<sup>179</sup> states:

- 'The purposes of this Act are to –
- (a) promote compliance with the Bill of Rights as provided for in the Constitution, in the application of company law;
  - (b) promote the development of the South African economy by –
    - (i) encouraging entrepreneurship and enterprise efficiency;
    - (ii) creating flexibility and simplicity in the formation and maintenance of companies; and
    - (iii) encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation
  - ...
  - (j) balance the rights and obligations of shareholders and directors within companies;
  - (j) encourage the efficient and responsible management of companies;
  - ...

The purpose of this Act concurs with King IV in that it emphasizes compliance with the Bill of Rights whilst promoting high standards of corporate governance. King IV also accentuates the importance of effective risk management and oversight over all aspects of the business.<sup>180</sup> In particular, responsibility and accountability over remuneration has been a focal point.<sup>181</sup> Disclosure requirements on remuneration have increased including more narratives on remuneration policy and implementation reports. King IV requires that remuneration be linked to performance in accordance with relevant Key Performance Indicators ('KPI's'), and should not only be driven by financial metrics. The principals of transparency and fairness play a key role in ensuring this.<sup>182</sup>

Whilst remuneration policies should be attractive to retain talent, they should also be aligned to the strategic objectives of the business. Disclosures on remuneration should include any variable remuneration, incentives or deferrals in addition to the base salary as well as information on any clawback provisions. Remuneration policy should also explain how executive remuneration fares in relation to remuneration of other lower-level employees.<sup>183</sup>

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<sup>177</sup> IODSA, 2016: 22 and 25

<sup>178</sup> IODSA, 2016: 23

<sup>179</sup> Companies Act, 2008: s 7

<sup>180</sup> IODSA, 2016: 61

<sup>181</sup> IODSA, 2016: 66-67

<sup>182</sup> IODSA, 2016: 30-31

<sup>183</sup> IODSA, 2016: 65

This view is supported by s 30(4) and s 30(6) of the Companies Act<sup>184</sup> which requires that director's emoluments and any benefits received be appropriately disclosed in the annual financial statements. This includes all performance incentives and bonuses paid out to directors in lieu of services rendered.

'30 (4) - The annual financial statements of each company that is required in terms of this Act to have its annual financial statements audited, must include particulars showing –

(a) the remuneration, as defined in subsection (6), and benefits received by each director, or individual holding any prescribed office in the company;

...'

'30 (6) - For the purposes of subsections (4) and (5), "remuneration" includes –

(a) fees paid to directors for services rendered by them to or on behalf of the company, including any amount paid to a person in respect of the person's accepting the office of director;

(b) salary, bonuses and performance-related payments;

...'

In a study conducted by PwC,<sup>185</sup> it was found that remuneration disclosures have improved in listed companies. A component of the remuneration reports focused on the company's future strategy and plans for implementation, whilst the remainder provided an overview on past performance. This approach allows for easier stakeholder engagement and corresponds to the objectives of King IV. King IV's governance mechanisms on remuneration however, have been criticized for not being tough enough on managing executive pay, in addition to being detached from global practice.<sup>186</sup>

#### **4.8 TAXATION AND OTHER LEGISLATIVE IMPLICATIONS OF THE CLAWBACK**

With respect to the clawback of incentive awards paid to employees, the ITA does not provide specific guidance on the tax treatment. From the above discussion, it was noted that the issue of cash or share based incentive awards have income tax consequences, employees' tax consequences and in certain cases capital gains tax consequences. Clawbacks provisions are enforced subsequent to payment of an award to the employee, in the event of fraud, reputational damage, non-performance or any other form of misconduct being identified.

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<sup>184</sup> Companies Act, 2008: s 30(4) and s 30(6)

<sup>185</sup> PwC, 2015: 12

<sup>186</sup> Bussin & Christos, 2016: 37

According to Stiglingh et al.,<sup>187</sup> SARS distinguishes between civil and criminal offences, with the onus of proof being the key determinant. In a civil matter, the taxpayer bears the onus of proving that tax was not underpaid.<sup>188</sup> In a criminal case, however, SARS is responsible to prove that an offence was committed by the taxpayer. According to ss 234 – 238 of TAA,<sup>189</sup> criminal offences include any erroneous, false, non-disclosure or incomplete disclosure made to SARS, as well as any attempt to evade tax. It also includes misrepresentation of accounts, fabricated statements, concealment of material facts and fraud. Where a taxpayer has wilfully engaged in any such activity, he is liable for having committed a criminal offence, unless he can prove that he was unaware of the misconduct and this ignorance is not due to negligence.<sup>190</sup> Criminal offences carry a penalty of a fine or imprisonment up to 5 years depending on the severity of the case.<sup>191</sup>

According to s 99(1)<sup>192</sup> of TAA, a taxpayer is afforded a 3-year period subsequent to the submission date of the original assessment to make any amendments to a tax return. SARS may withdraw the original assessment and issue a revised assessment where necessary.<sup>193</sup> After this 3-year period, SARS may not issue any additional assessments except in the case of fraud, misrepresentation or non-disclosure of material facts as indicated in s 99(2)(a) of TAA below.<sup>194</sup>

(2) Subsection (1) does not apply to the extent that -

- (a) in the case of assessment by SARS, the fact that the full amount of tax chargeable was not assessed, was due to -
  - (i) fraud;
  - (ii) misrepresentation; or
  - (iii) non-disclosure of material facts;
  - ...

This implies that where a taxpayer genuinely made a mistake in a tax return, a 3-year grace period is granted to rectify the error. In cases of intentional misrepresentation, fraud or misconduct, however, SARS reserves the right to investigate prior years submissions to ensure that all amounts due to the fiscus were not underpaid. Where incentive awards are clawed back, currently s 99 of TAA does not allow the taxpayer to amend prior year returns to reverse the tax

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<sup>187</sup> Stiglingh et al., 2018: 1077

<sup>188</sup> TAA, 2011: s 102

<sup>189</sup> TAA, 2011: ss 234-238

<sup>190</sup> TAA, 2011: s 235(2)

<sup>191</sup> TAA, 2011: ss234 – s238

<sup>192</sup> TAA, 2011: s 99(1) and SARS, 2018d

<sup>193</sup> TAA, 2011: s 98(2)

<sup>194</sup> TAA, 2011: s 99(2)(a)

consequences incurred by the taxpayer in relation to the awards refunded to the employer. Instead, SARS may choose to conduct further investigations depending on the nature of the misconduct identified, and will institute appropriate action as detailed above.

Section 34(2)<sup>195</sup> of the Basic Conditions of Employment Act 71 of 1997 ('BCEA') allows the employer to recoup amounts from the remuneration of an employee in the case of losses or damages caused by the employee. This deduction is capped at a quarter of the total remuneration payable. Section 34(5)<sup>196</sup> included below further permits the employer to recover any excess remuneration paid to employees, if found to be erroneously calculated.

'34 (5) An employer may not require or permit an employee to:

- (a) repay any remuneration except for overpayments previously made by the employer resulting from an error in calculating the employee's remuneration; or

...'

This section affords employers the opportunity to clawback surplus amounts overpaid if resulting from a mathematical calculation error.

According to the Code of Good Practice in the Labour Relations Act 66 of 1995 ('LRA'), employers are entitled to good conduct and acceptable work performance from the employees.<sup>197</sup> If conduct or work performance is unsatisfactory, the employer may take corrective action through disciplinary procedures and the issue of warnings.<sup>198</sup> Severe cases of misconduct or recurrent offences may warrant a dismissal. Whilst taking cognizance of all relevant facts, the LRA<sup>199</sup> indicates that a dismissal is appropriate for

'Schedule 8 – s 3(4) - gross dishonesty or wilful damage to the property of the employer, wilful endangering of the safety of others, physical assault on the employer, a fellow employee, client or customer and gross insubordination.'

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<sup>195</sup> BCEA, 1997: s 34(2)

<sup>196</sup> BCEA, 1997: s 34(5)

<sup>197</sup> LRA, 1995: Schedule 8 – s 2

<sup>198</sup> LRA, 1995: Schedule 8 – s 3

<sup>199</sup> LRA, 1995: Schedule 8 – s 3(4)

## 4.9 SUMMARY

In summary, from a remuneration point of view, the BCEA allows employers to recoup excess amounts that were paid to employees resulting from numerical computation errors. This Act is only applicable to individuals in an employer-employee relationship. Section 11(nA)<sup>200</sup> does provide some relief to the taxpayer if amounts are reimbursed to the employer during the same tax year. The funds recovered are reinvested into the business in an effort to minimize the financial loss arising from the employee's deceptive conduct. In addition to this, the employer may take disciplinary action against the employee and depending on the severity of the case, a dismissal may be effected.

Subsequent to termination of employment, listed companies are currently pursuing legal means to recover funds from former executives. Where an act of misconduct is detected years after the payment of remuneration, there is currently no framework locally specifying how this should be done. Instead, the board of directors and the remuneration committee are applying policies drafted in-house leading to inconsistency in application between companies.

From a taxation perspective, income tax, employees' tax and capital gains tax (where applicable) would have been paid on these incentive awards once they accrue to the employee as discussed above. The trigger events for the clawback of incentive awards that are currently used in practice are in most cases similar in nature to those used by SARS in determining what constitutes a criminal offence. SARS would however conduct the necessary investigations to determine the severity of the misconduct, and then determine the appropriate response.

If the clawback provision is enforced in the same year of assessment as when the award is paid out, the employee benefits in that the incentive award once clawed back will have a nil impact in the tax return. In substance, it is as though the employee never received the award. The employer recoups the cash from the employee and may also request a suspension on the payment of PAYE to SARS while this matter is under investigation.<sup>201</sup>

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<sup>200</sup> ITA, 1962: s 11(nA)

<sup>201</sup> SARS, 2018d

If however, the awards are clawed back in a subsequent year of assessment; SARS provides no relief to the taxpayer despite having paid the taxation on the incentive awards received prior to the enforcement of the clawback provisions. Moreover, the legislation at present does not allow for the recovery of the SDL and UIF previously paid on the amounts clawed back. In addition to this, SARS may investigate prior year submissions to ensure that taxes were not underpaid. Currently legislation in South Africa does not allow for the recovery of the income taxes paid to SARS with respect to these awards, thereby resulting in an overall loss for the employer and employee. In addition, the employee may still be liable for legal costs and penalties.

## **5. CHAPTER THREE – USA TAX IMPLICATIONS**

Terms that are frequently used in this research report with respect to USA income tax are defined below. Where necessary, these definitions have been repeated in the discussion for ease of reference.

### **5.1 KEY DEFINITIONS**

Included below are definitions of terms frequently used in this chapter:

#### **'Covered employee'<sup>202</sup>**

For purposes of this subsection, the term “covered employee” means any employee of the taxpayer if -

(A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or

(B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).'

#### **'Director'<sup>203</sup>**

The term “director” means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.'

#### **'Employee'<sup>204</sup>**

For purposes of this chapter, the term “employee” includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof...'

'Revenue ruling 2006-18<sup>205</sup> states that 'Section 31.3401(c)-1 of the Employment Tax Regulations provides that the term “employee” includes every individual performing services if the relationship between that individual and the person for whom he performs such services is the legal relationship of employer and employee.'

#### **'Employer'<sup>206</sup>**

For purposes of this chapter, the term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that -

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<sup>202</sup> IRC, 1986: s 162(m)(3)

<sup>203</sup> SEA, 1934: s 3(7)

<sup>204</sup> IRC, 1986: s 3401(c)

<sup>205</sup> IRS, 2006: 4

<sup>206</sup> IRC, 1986: s 3401(d)

- (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services ...'

'Executive Officer'<sup>207</sup>

An "executive officer" would be the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. Executive officers of the issuer's parents or subsidiaries would be deemed executive officers of the issuer if they perform such policy-making functions for the issuer.'

'Executive remuneration'<sup>208</sup>

For purposes of this paragraph, the term "executive remuneration" means the applicable employee remuneration of the covered executive, as determined under paragraph (4) without regard to subparagraphs (B), (C), and (D) thereof. Such term shall not include any deferred deduction executive remuneration with respect to services performed in a prior applicable taxable year.'

'Remuneration'<sup>209</sup>

For purposes of this paragraph, the term "remuneration" includes any remuneration (including benefits) in any medium other than cash, but shall not include -

- (i) any payment referred to in so much of section 3121(a)(5) as precedes subparagraph (E) thereof, and
- (ii) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter.'

## 5.2 BACKGROUND AND INTRODUCTION

In response to the global financial crisis, the federal government introduced a number of legislative processes in an attempt to recover amounts paid out to executives who did not act in the best interest of the company. The manner of recovery has been described below with reference to Sarbanes-Oxley, Dodd-Frank and s 10D of the Securities Exchange Act of 1934 ('SEA').

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<sup>207</sup> SEC, 2015: 34

<sup>208</sup> IRC, 1986: s 162(E)

<sup>209</sup> IRC, 1986: s 162(m)(4)(E)

### 5.3 SARBANES-OXLEY

Non-adherence to financial reporting requirements due to misconduct is governed by s 304 of the Sarbanes-Oxley Act of 2002 ('SOX'). This section provides the Securities Exchange Commission ('SEC') with a year subsequent to the offence in which to demand repayment of any incentive-awards granted to the CEO or CFO of a company. Once the SEC recovers the amounts, the employer is then reimbursed accordingly. This applies to both cash and equity-based incentive awards.<sup>210</sup> Section 304<sup>211</sup> of SOX states,

'(a) If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for -

- (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
- (2) any profits realized from the sale of securities of the issuer during that 12-month period.

...'

SOX allows the SEC to recoup the full amount of the award paid out. The SOX clawback only applies to public companies and is only applicable if an act of misconduct has occurred that results in an accounting restatement.<sup>212</sup> Schwartz<sup>213</sup> points out that executives may keep the base salary initially paid out to them. Only the portion of remuneration that is classified as an incentive award is subject to clawback under s 304. It should be noted that the act of misconduct need not be carried out by the CEO or CFO directly. If any member of the executive engages in such acts, the SOX clawback may be effected.<sup>214</sup> The purpose of this clawback is to hold the CEO and CFO accountable for creating an internal control environment that operates effectively in an effort to identify and timeously address acts of misconduct so that any restatement to financial results is avoided.<sup>215</sup> This purpose correlates to s 302<sup>216</sup> of SOX, which states:

'(a) ... the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that –

- (1) the signing officer has reviewed the report;

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<sup>210</sup> SOX, 2002: s 304(a)(1)

<sup>211</sup> SOX, 2002: s 304(a)

<sup>212</sup> Fried & Shilon, 2011a: 730

<sup>213</sup> Schwartz, 2008: 32-33

<sup>214</sup> Fried & Shilon, 2011a: 740

<sup>215</sup> Schwartz, 2008: 18-19

<sup>216</sup> SOX, 2002: s 302

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers -

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

...'

In recent years however, the implementation of the SOX clawback has proven to be a lengthy process in that executives first needed to be found guilty of a transgression before the SEC could demand repayment.<sup>217</sup> Fried & Shilon<sup>218</sup> also indicate that the implementation of the SOX clawback discourages executives to perform well and contribute to value creation in the business, as incentive awards are at risk of forfeiture should any wrongdoing subsequently be discovered. Furthermore, the employer is not afforded the opportunity to recoup the amounts paid directly from the executives concerned. This SEC bears this responsibility.<sup>219</sup> As such, the enforceability of the SOX clawback became an onerous and inefficient process.

## 5.4 DODD-FRANK

In response to the global financial crisis, in 2008, the Troubled Asset Relief Program ('TARP') was initiated in which the federal government provided capital injections to companies to facilitate economic recovery. This program allowed the treasury to recover large sums of money from companies, but was also harshly criticized for allowing executives to receive bonuses in spite of the economic recession.<sup>220</sup> Shortly thereafter, in 2010, the Dodd-Frank Wall Street Reform and

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<sup>217</sup> Fried & Shilon, 2011b: 2-3

<sup>218</sup> Fried & Shilon, 2011a: 731

<sup>219</sup> Fried & Shilon, 2011a: 731

<sup>220</sup> Anon, 2018

Consumer Protection Act ('Dodd-Frank') was introduced. According to Kenton,<sup>221</sup> this act aimed to curb the devastating effects of the global financial crisis by introducing legislative provisions to stabilize the economy and to protect consumers from high-level abuse of the financial system. Bussin & Christos<sup>222</sup> explain that the purpose of this act was also to bridge the remuneration gap between high and low income earners. Executive accountability and transparency came to the fore and as such, the need to regulate executive pay arose.<sup>223</sup>

In an effort to effectively manage executive compensation, Dodd-Frank requires public companies to include clawback provisions as part of their incentive awards in an effort to discourage misrepresentation of financial results. In the event of any restatement of financial results due to initial falsification of amounts, employers have the right to recoup the excessive portion of awards already paid out.<sup>224</sup> This is in contrast to SOX, which allows for the recoupment of the full amount of the incentive award.

Dodd-Frank requires shareholder approval every 3 years for compensation issued to executives.<sup>225</sup> Disclosure is required for the correlation between compensation actually paid out to executives and financial performance of the company.<sup>226</sup> The ratio of median annual compensation paid to employees as a percentage of total annual compensation paid to the CEO also needs to be disclosed.<sup>227</sup> Companies are obliged to draft and implement policies governing the clawback of funds in the event of a restatement to the financials, provided the restatement resulted from defiance of financial reporting requirements.<sup>228</sup> For covered institutions in particular, s 956 further requires the regulator to determine whether incentive compensation paid to executives is excessive and whether the existing remuneration structures could adversely affect the financial position of the company.<sup>229</sup>

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<sup>221</sup> Kenton, 2019b

<sup>222</sup> Bussin & Christos, 2016: 36

<sup>223</sup> Bussin & Christos, 2016: 37

<sup>224</sup> Fried & Shilon, 2011b: 1

<sup>225</sup> Dodd-Frank, 2010: s 951(1) and SEA, 1934: s 14A[78n-1](a)(1)

<sup>226</sup> Dodd-Frank, 2010: s 953 and SEA, 1934: s 14(5)(i)

<sup>227</sup> Dodd-Frank, 2010: s953(b)(1) and Bachelder, 2015

<sup>228</sup> Dodd-Frank, 2010: s954(b)

<sup>229</sup> Dodd-Frank, 2010

According to Fried & Shilon,<sup>230</sup> the Dodd-Frank clawback applies irrespective of whether an act of misconduct has occurred, and places the responsibility of enforcement upon the employer, rather than on the SEC or other regulatory authorities. One of the shortfalls of Dodd-Frank is that it limits the application of a clawback to cases of misrepresentation of financial results that necessitate an accounting restatement, whilst overlooking other types of non-financial misconduct.<sup>231</sup>

## 5.5 SECTION 10-D

In 2015, the SEC introduced s 10D, applicable to listed companies as part of the SEA.<sup>232</sup> This section provided further detail of the application of s 954<sup>233</sup> of Dodd-Frank. Section 10D(a) requires all listed companies to adopt, disclose and enforce policies relating to the clawback of incentive awards, or the companies could face delisting.<sup>234</sup> Board<sup>235</sup> further illustrates that this section brought the concept of ‘earning’ into incentive awards. Where an accounting restatement occurs, it should be determined whether or not the executives involved earned their compensation prior to the restatement. If compensation was not earned, then it may be recouped from current or former executives. This concept of earning has tax implications for the employer and the executives receiving the awards. As defined above, executive officers include directors as well as employees involved in strategic decision-making roles in the business.

Section 10D(b)(2)<sup>236</sup> states the following:

‘(b) The rules of the Commission under subsection (a) shall require each issuer to develop and implement a policy providing –

...

- (2) ...the issuer will recover from any current or former executive officer of the issuer who received incentive- based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.’

<sup>230</sup> Fried & Shilon, 2011b: 5 and Fried & Shilon, 2011a: 745

<sup>231</sup> Fried & Shilon, 2011b: 1

<sup>232</sup> SEA, 1934: s 10D

<sup>233</sup> Dodd-Frank, 2010

<sup>234</sup> SEA, 1934

<sup>235</sup> Board, 2015: 1

<sup>236</sup> SEA, 1934

This illustrates that where an accounting restatement occurs; executive compensation will be recomputed for a period of 3-years prior to it to determine any excess amounts paid out to executives. The 3-year period is referred to as a 'look-back period'.<sup>237</sup> These surplus amounts will then be recouped from current or former executives in accordance with this section.<sup>238</sup> The Listing Standards for Recovery of Erroneously Awarded Compensation clarify that the restatement must be 'to correct an error that is material to previously issued financial statements'.<sup>239</sup>

In essence, the amount that the executives should not have received had the accounting rules been correctly applied, will be recovered.<sup>240</sup> Bachelder<sup>241</sup> adds that this clawback applies irrespective of whether or not the executive was responsible for the restatement. This concept is referred to as 'no fault recovery'.<sup>242</sup> Furthermore, the amount clawed back would be the gross amount paid out, before any taxes in accordance with s 10D-1(b)(1)(iii).<sup>243</sup> According to Kesner et al.,<sup>244</sup> the purpose of recovery on a pre-tax basis is to ensure that the company is fully reimbursed for the excess amounts initially paid out in error.

Incentive based compensation is defined in s 10D-1(c)(4) as 'any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure', and includes both cash and equity-based awards.<sup>245</sup> Financial reporting measures are defined as,

"...measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return (TSR)."<sup>246</sup>

Any equity or cash awards that are linked to time, strategic, operational or any measure other than a financial reporting measure are excluded from this definition.<sup>247</sup> Discretionary and retention bonuses are also excluded from the scope of s 10D.<sup>248</sup> Therefore, in order for this section to apply, the accounting error must have had an impact on a financial reporting measure that was used

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<sup>237</sup> SEC, 2015: 29 and Bachelder, 2015

<sup>238</sup> SEA, 1934 and SEC, 2015: 35

<sup>239</sup> SEC, 2015: 24

<sup>240</sup> SEC, 2015: 22

<sup>241</sup> Bachelder, 2015 and SEC, 2015: 61

<sup>242</sup> Kesner et al., 2015: 1 and SEC, 2015: 68

<sup>243</sup> Bachelder, 2015 and SEC, 2015: 61

<sup>244</sup> Kesner et al., 2015: 6

<sup>245</sup> Kesner et al., 2015: 4 and SEC, 2015: 41

<sup>246</sup> SEC, 2015: 41 and Kesner et al., 2015: 4

<sup>247</sup> Bachelder, 2015

<sup>248</sup> Kesner et al., 2015: 4 and SEC: 2015, 46-47

initially in determining the amount of compensation payable to the executives concerned.<sup>249</sup> Kesner et al. indicates that equity awards, the vesting or granting of which are tied to service metrics, are precluded from the scope of s 10D.<sup>250</sup> Furthermore, only certain types of retrospective financial adjustments trigger the application of the clawback. Changes to accounting policies, review of provisional amounts, changes to segment information or classification as a discontinued operation are amongst others examples of retrospective adjustments that do not trigger the clawback.<sup>251</sup>

Regarding the date of receipt, s 10D(1)(c)(6)<sup>252</sup> indicates that the award is deemed to be received:

‘... in the issuer’s fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period.’

This implies that the date of receipt is the earlier of the date on which the award became earned by the executive and the date of actual payment. An award may only be recouped after it was deemed to be received.<sup>253</sup> The objective of s 10D is to recover amounts paid to executives that should not have been paid had the financial records been correctly presented as mentioned above. In line with this objective, compensation needs to have been rightfully earned. The SEC defines the ‘earning’ to be when ‘an executive officer obtains a non-forfeitable interest in a compensatory award’.<sup>254</sup>

In cases where an award is subject to several conditions, not all conditions need to be met before the executive obtains a ‘non-forfeitable’ interest in the award.<sup>255</sup> The fulfilment of the financial criteria is sufficient to create an obligation on the part of the company to pay the award and a contingent right on the part of the executive to receive the award.<sup>256</sup> Any other type of non-financial metric or performance criteria is ignored for the purposes of determining whether an executive has a non-forfeitable interest in an award. Once the contingent right to the award is established,

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<sup>249</sup> SEC, 2015: 106

<sup>250</sup> Kesner et al., 2015: 4-5

<sup>251</sup> Kesner et al., 2015: 2

<sup>252</sup> SEC, 2015: 53-54 and Bachelder, 2015

<sup>253</sup> SEC, 2015: 56

<sup>254</sup> SEC, 2015: 53

<sup>255</sup> SEC, 2015: 54

<sup>256</sup> SEC, 2015: 54-55

the amounts are subject to clawback in accordance with s 10D even if other underlying conditions attached to an award have not been satisfied.<sup>257</sup>

According to Fuerst & Sengar,<sup>258</sup> the date of enforcement of s 10D is the date on which the company is required to make an accounting restatement. This date is the earlier of the date on which the board of directors have resolved that a material error exists, or the date on which a court concludes that the financial results require a restatement.

The concept of materiality plays a key role in determining whether to enforce a clawback. The Listing Standards for the Recovery of Erroneously Awarded Compensation<sup>259</sup> states,

'We do not propose to describe any type or characteristic of an error that would be considered material for purposes of the listing standards required by proposed Rule 10D-1<sup>260</sup> because materiality is a determination that must be analyzed in the context of particular facts and circumstances. Moreover, materiality has received extensive and comprehensive judicial and regulatory attention. We note that issuers should consider whether a series of immaterial error corrections, whether or not they resulted in filing amendments to previously filed financial statements, could be considered a material error when viewed in the aggregate.'

The use of judgement is therefore necessary in determining materiality, and all relevant facts should be considered. According to the SEC,<sup>261</sup> any delay in reporting a material accounting error, whether intentional or not may result in criminal liability on the part of the executive and the company involved. The classification of an error as immaterial, whilst actually being material also carries the same penalty.

With respect to share incentive awards, if the shares are held by the executive at the time of clawback, the amount to be recouped would be the excess shares received by the executive. If these shares were initially acquired through the exercise of an option and the shares are currently held, the amount clawed back is reduced by any exercise price paid for the acquisition of such

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<sup>257</sup> SEC, 2015: 55

<sup>258</sup> Fuerst & Sengar, 2016

<sup>259</sup> SEC, 2015: 25

<sup>260</sup> Note that Rule 10D refers to s 10D of the Securities Exchange Act of 1934. These terms are used interchangeably in the SEA, 1934 and the Listing Standards for the Recovery of Erroneously Awarded Compensation.

<sup>261</sup> SEC, 2015: 121

shares. If however, the shares are sold, the portion of the proceeds relating to the excess shares is subject to clawback.<sup>262</sup>

All individuals in key management roles, key finance roles as well as those tasked with the responsibility of policy-making are regarded as executives in the company and are subject to the clawback rules according to s 10D-1(c)(3).<sup>263</sup> Section 10D-1(b)(1)(v) precludes companies from indemnifying executives in their employ from the enforcement of a clawback.<sup>264</sup> This is also supported by s 29(a) of the SEA,<sup>265</sup> which states,

'Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.'

Therefore, any action that requires non-compliance with the SEA is null and void. Indemnifying executives from returning excessive compensation received contravenes s 10D, hence companies are prohibited from doing this.<sup>266</sup>

Section 10D also limits the discretion of the board in enforcing the clawback provisions. Therefore, an attempt must be made to recover erroneously awarded compensation.<sup>267</sup> Non-application of s 10D is only permitted in cases where the amount to be recovered exceeds the cost of recovery, or where recoupment contravenes a country's national law.<sup>268</sup> The manner of recovery however is left to the discretion of the company issuing the award. Several mechanisms are available such as cancelling unvested awards, forfeiting awards and deduction from future pay amongst others.<sup>269</sup>

According to the Listing Standards for Recovery of Erroneously awarded Compensation, there may be situations where s 10D and s 304 of SOX apply to the same incentive award. In such cases, s 304 of SOX takes preference. To the extent that amounts recovered under s 304, they

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<sup>262</sup> Kesner et al., 2015: 6 and SEC, 2015: 62-63

<sup>263</sup> SEC, 2015: 32-35 and Bachelder, 2015

<sup>264</sup> Bachelder, 2015 and SEC, 2015: 95

<sup>265</sup> SEA, 1934: s 29(a) and SEC, 2015: 95-96

<sup>266</sup> SEC, 2015: 95-96

<sup>267</sup> SEC, 2015: 69

<sup>268</sup> Bachelder, 2015

<sup>269</sup> SEC, 2015: 75

will be deducted in determining the amounts due under s 10D.<sup>270</sup> In contrast to the SOX clawback, s 10D refers to non-fulfilment by the company with the prerequisites in financial reporting. The role of senior executives in such activity is irrelevant.<sup>271</sup> In addition to this, misconduct need not exist in order for s 10D to apply.<sup>272</sup>

According to Fried & Shilon,<sup>273</sup> clawbacks are also used in cases where the reckless behaviour of executives compounds the risk exposure of companies, irrespective of whether or not financial metrics were satisfied. These are referred to as insolvency clawbacks, as government bailouts are usually required to remedy the situation. This type of clawback differs to the excess pay clawback discussed above, but nonetheless is relevant as due to the huge reputational and economic impact that such irresponsible risk-taking may have.

## **5.6 MANNER OF RECOVERY AND THE NECESSARY INCOME TAX IMPLICATIONS**

The clawback of incentive awards may occur in various ways, each having different tax implications. Clawback may be effected through repayment from the employee or alternatively through the withholding of such amounts from future remuneration payable.<sup>274</sup> The following scenarios exist:

### Scenario One:

Payment and clawback within the same tax year (existing employees)

- a. Clawback by repayment
- b. Clawback by withholding future remuneration

### Scenario Two:

Payment and clawback in a subsequent tax year (existing employees)

- a. Clawback by repayment

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<sup>270</sup> SEC, 2015: 63 and Kesner et al., 2015: 6

<sup>271</sup> SEC, 2015: 110

<sup>272</sup> SEC, 2015: 111

<sup>273</sup> Fried & Shilon, 2011a: 724

<sup>274</sup> Barker & O'Brien, 2010: 424

b. Clawback by withholding future remuneration

Scenario Three:

Clawback from former employees

Each scenario is discussed in further detail below:

**5.6.1 Scenario One**

**Payment and clawback within the same tax year (existing employees)**

- a. Clawback by repayment
- b. Clawback by withholding future remuneration

**5.6.1(a) - Tax Consequences for the Employer**

If compensation paid to an executive is clawed back in the same financial year, no tax consequences arise for the employer. The initial deduction of the payment of the compensation is set off by the reimbursement from the executive. Irrespective of whether the clawback was effected through a repayment or through the withholding of future remuneration, the transaction is construed not to have occurred, and therefore no tax consequences result.<sup>275</sup> This is in accordance with Revenue ruling 79-311. Holmes<sup>276</sup> explains this ruling as follows:

'Rev. Rul. 79-311 held that, generally, the advances were income to the employees at the time of receipt. With respect to the advances that were repaid in the same year they were received, such advances were held to be excludable from the gross income of the employee. With respect to the excess advances that were repaid by *the taxpayer*<sup>277</sup> in the year subsequent to the year received, the ruling holds that *the taxpayer* may not exclude from *the taxpayer's* gross income the amount of such repayments. The ruling concludes that *the taxpayer* is entitled to a deduction in the year of repayment of that portion of the repayment used to restore advances received in prior years. The ruling concludes that the repayment is deductible from *the taxpayer's* adjusted gross income in computing taxable income and is allowable only if *the taxpayer* itemizes deductions.'

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<sup>275</sup> Barker & O'Brien, 2010: 424

<sup>276</sup> Holmes, 1998: 5-6

<sup>277</sup> Throughout this extract, the taxpayer's name has been replaced by the words 'the taxpayer' in italics.

### **5.6.1(b) - Tax Consequences for the Executive**

Initially upon receipt of the compensation, the executive is liable for income tax, as the amount constitutes gross income as defined in s 61(a)<sup>278</sup> of the IRC.

'Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

...'

If the executive is required to reimburse the employer for the compensation received in the same calendar year, no tax consequences arise for the executive.<sup>279</sup> In essence, the income received by the executive is offset by the repayment, having a net nil tax effect in line with Revenue ruling 79-311 mentioned above.

### **5.6.2 Scenario Two**

#### **Payment and clawback in a subsequent tax year (existing employees)**

- a. Clawback by repayment
- b. Clawback by withholding future remuneration

#### **5.6.2(a) - Tax Consequences for the Employer**

During the year of initial payment, the employer discloses the full amount paid out to the employee. In a subsequent year when amounts are clawed back, the employer is still obliged to disclose the gross value of income accruing to the employee, without taking into account any repayments received.<sup>280</sup> Where an employer enforces the clawback through withholding future remuneration, the gross amount due to the employee is still disclosed for IRS reporting purposes,

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<sup>278</sup> IRC, 1986: s 61(a)

<sup>279</sup> Kesner et al., 2015: 14 and Barker, 2015: 8

<sup>280</sup> Barker & O'Brien, 2010: 424

even though a lesser amount will actually be paid.<sup>281</sup> This prudent approach allows the IRS to recover taxes on the total amount of income paid out to employees in each tax year, whilst also limiting employer's exposure to penalties arising from non-disclosure.<sup>282</sup>

Barker & O'Brien<sup>283</sup> explain that in certain cases, where employees are not compelled to refund amounts previously received from their employers, such amounts may be set off from future remuneration and disclosed as such to the IRS. This usually occurs with advance payments granted by the employer, which are subsequently earned by the employee over a period. In the year of grant, the full amount of the advance is included in gross income and is taxed accordingly. In later years, the net amount earned by the employee is disclosed to the IRS. This, in effect prevents double taxation on the same amount.<sup>284</sup> This approach has been accepted by the IRS and the Federal courts as it conforms to the claim of right doctrine, which is explained in further detail below.<sup>285</sup>

Upon initial payment, the employer deducts the incentive award paid to the employee, and includes it in the employees' gross income, as mentioned above. Once this amount is clawed back, the employer is obliged to include it in the gross income of the company in accordance with the tax benefit rule.<sup>286</sup> The tax benefit rule is governed by s 111(a)<sup>287</sup> of the IRC, which states,

'Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed...'

Carpenter<sup>288</sup> indicates that the tax benefit rule tackles the difference in timing between the tax year when the initial payment was made and the year in which the refund was received. In the year of initial payment, if the company benefited from a deduction in taxable income, then in the year of recoupment, such amounts should be included in taxable income in accordance with the

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<sup>281</sup> Barker & O'Brien, 2010: 424

<sup>282</sup> Barker & O'Brien, 2010: 424

<sup>283</sup> Barker & O'Brien, 2010: 427

<sup>284</sup> Barker & O'Brien, 2010: 427

<sup>285</sup> Barker & O'Brien, 2010: 427

<sup>286</sup> Barker & O'Brien, 2010: 435

<sup>287</sup> IRC, 1986: s 111

<sup>288</sup> Carpenter, 2010

above section. If, for any reason, the company did not deduct the amount from income initially in the year of payment, then no inclusion in income is necessary when the amount is reimbursed.<sup>289</sup>

In accordance with this view, where the clawback occurs in a later year, the deduction previously claimed for the payment of compensation would need to be reversed to the extent that the amounts have been refunded.<sup>290</sup>

According to s 404(a)(5) of the IRC,<sup>291</sup>

‘...deferred compensation shall be deductible for the taxable year of the employer in which paid to the employee.’

Where an employer contributes to a bonus scheme for employees, the payment of which is deferred, the company qualifies for a deduction under the above-mentioned section in the year of assessment in which the employee declares the income. Barker<sup>292</sup> indicates that in practice a 2.5-month period is available when determining the year of assessment in which to account for the deduction. If the compensation is received after 2.5-months since the company’s year-end, the deduction is accounted for in the year that the employee declares the income. If however, the compensation is received within 2.5-months of the company’s year-end, the deduction is accounted for in the year of accrual. The employee on the other hand is deemed to receive the compensation upon payment by the employer, or when made available without any significant restrictions.<sup>293</sup> According to s 10D stated above, amounts are deemed to be received once financial metrics have been satisfied.

With respect to the clawback of compensation paid out in a prior year, s 10D applies in conjunction with the tax benefit rule. The three-year lookback period is considered to determine the excessive amount erroneously paid out. Once this is determined in accordance with s10D, s 111(a) requires

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<sup>289</sup> Carpenter, 2010

<sup>290</sup> Kesner et al., 2015: 14

<sup>291</sup> IRC, 1986: s 404(a)(5)

<sup>292</sup> Barker, 2015: 4

<sup>293</sup> Barker, 2015: 4

the inclusion of this amount in gross income of the company in the year of receipt.<sup>294</sup> It should be noted that if s 10D is not applicable, the clawback may be enforced under s 304 of SOX.

### 5.6.2(b) - Tax Consequences for the Executive

Barker & O'Brien<sup>295</sup> indicate that an employee is not allowed to amend a tax return relating to a prior year. Furthermore, Barker<sup>296</sup> indicates that in the year of clawback, the company is obligated to disclose to the IRS remuneration paid to the employee on a gross basis, except in the case of advance payments, as illustrated above. Therefore, any amount repaid by the employee, or withheld by the employer from remuneration for the current year cannot be netted off for reporting purposes in accordance with Revenue ruling 79-311.<sup>297</sup> The employee is therefore afforded an opportunity to reclaim taxes paid on recouped amounts directly from the IRS.

Revenue ruling 79-311 allows for amounts erroneously received by an employee and refunded to the employer in a subsequent year to be deducted. Section 162(a)<sup>298</sup> of the IRC allows for the deduction of such amounts as a business expense.<sup>299</sup> Section 162(a)<sup>300</sup> states:

'There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including –

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

...'

As such, executives may be able to deduct the portion of incentive awards recouped by the employer in a subsequent year as a business expense.<sup>301</sup> Alternatively, executive may recover the amount repaid as a loss under s 165(a) and (c)<sup>302</sup> of the IRC,

'(a) There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

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<sup>294</sup> Barker, 2015: 5 and 6

<sup>295</sup> Barker & O'Brien, 2010: 424

<sup>296</sup> Barker, 2015: 9

<sup>297</sup> Barker, 2015: 9

<sup>298</sup> IRC, 1986: s 162(a)(1)

<sup>299</sup> Scott, 2018

<sup>300</sup> IRC, 1986: s 162(a)(1)

<sup>301</sup> Board, 2015: 3

<sup>302</sup> IRC, 1986: s 165(a) and (c) ; Board, 2015: 2 and Barker, 2015: 9

...

(c) In the case of an individual, the deduction under subsection (a) shall be limited to -

- (1) losses incurred in a trade or business;
- (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business' and
- (3) losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

...'

Barker & O'Brien<sup>303</sup> and Kesner et al.<sup>304</sup> indicate that both ss 162 and 165 are subject to the rules governing miscellaneous itemized deductions. A miscellaneous itemized deduction is subject to particular limitations as described in s 67(a) of the IRC,<sup>305</sup>

'In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.'

It should be noted however that according to s 67(g)<sup>306</sup> of the IRC, the use of this deduction has been suspended for tax years between 31 December 2017 and 1 January 2026.

'Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.'

During the above-mentioned period, Fishman<sup>307</sup> further indicates that any fees incurred by the executive during negotiations with the IRS to receive any tax refunds or claims are also not deductible.

In light of this temporary suspension, Publication 525<sup>308</sup> of the IRS indicates that repayments up to a maximum of \$3 000 may not be deducted in the year of repayment. The taxpayer therefore forfeits the deduction for the repayment of the amount clawed back. The employer will however still have a gross income inclusion for this amount in accordance with the tax benefit rule as mentioned above. Repayments in excess of \$ 3 000 in aggregate may however be deducted in

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<sup>303</sup> Barker & O'Brien, 2010: 430

<sup>304</sup> Kesner et al., 2015: 14

<sup>305</sup> IRC, 1986: s 67(a)

<sup>306</sup> IRC, 1986: s67 (g)

<sup>307</sup> Fishman, n.d.

<sup>308</sup> IRS, 2019: 34 and Salam & Spyker, 2018: 6

the category of 'other itemized deductions' provided the taxpayer initially included the amount in income under the claim of right doctrine. This doctrine allows the taxpayer a reimbursement credit for taxes paid in prior years.<sup>309</sup>

The 'Claim of Right' doctrine as defined in s 1341(a)(1) stipulates 3 criteria:<sup>310</sup>

a. An unrestricted right to income exists

A taxpayer needs to possess an unrestricted right to an amount that was included in its gross income in a prior year.<sup>311</sup> A detailed examination of the facts and circumstances is necessary in determining whether an unrestricted right exists.<sup>312</sup> This is known as the 'apparent vs actual right test'.<sup>313</sup> Schnee<sup>314</sup> explains that the existence of an apparent right to the income is sufficient to warrant the application of s 1341. Actual rights are therefore not necessary. This view is also supported in numerous case law as quoted by Barker & O'Brien.<sup>315</sup>

Lehman<sup>316</sup> explains that an apparent right to income exists when the taxpayer believes that he a right to that income. An 'absolute, unchallengeable right' to the income need not exist at the time of inclusion into gross income. Moreover, any unrestricted right to income cannot exist for income that is wrongfully obtained through theft, fraud or embezzlement, amongst many others.<sup>317</sup>

b. Deductions are allowed if no unrestricted right exist is subsequently found to exist

If, in a subsequent year, no unrestricted right is found to exist with respect to the income received; no amount should have initially been included in gross income.<sup>318</sup> Schnee<sup>319</sup> emphasizes the need for a 'nexus' or link between the initial gross income inclusion and

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<sup>309</sup> IRS, 2019: 34 and Salam & Spyker, 2018: 6

<sup>310</sup> Schnee, 2003

<sup>311</sup> Board, 2015: 2 and 4 and IRS, 2019: 34

<sup>312</sup> Kesner, 2015: 14

<sup>313</sup> Barker, 2015: 12

<sup>314</sup> Schnee, 2003

<sup>315</sup> Barker & O'Brien, 2010: 432

<sup>316</sup> Lehman, 2014

<sup>317</sup> Lehman, 2014

<sup>318</sup> Board, 2015: 4

<sup>319</sup> Schnee, 2003

the subsequent deduction under s 1341. The facts in existence at the time are critical in determining this link.

c. Deduction exceeds \$3 000

As mentioned above, s 1341 only applies to aggregate deductions in excess of \$3 000 where a claim of right is proven to exist. Amounts less than \$3 000 were previously categorized as miscellaneous itemized deductions, however due to the current suspension these repayments are not deductible.<sup>320</sup>

Barker & O'Brien indicate that gross income includes amounts based on the claim of right doctrine, irrespective of any clawback policy being in place at the company that creates a contingent obligation on the part of the executive to repay the incentive award at any point in future.<sup>321</sup> In addition, Melone<sup>322</sup> mentions that the timing of the inclusion under the claim of right doctrine is at the end of the tax year without having any regard to events occurring thereafter.

Section 1341(a)(2)<sup>323</sup> states that in a subsequent year, if it can be established that the taxpayer did not have an unrestricted right to the amount included in gross income in a previous year, then that amount may be deducted in the current year. A taxpayer needs to provide sound reason to deduct an amount in the current year in order to claim a credit for taxes paid in prior years.<sup>324</sup>

The taxation for the current year (the year of repayment) would therefore be computed on the lower of:

- a) Taxable income for the current year incorporating the deduction (provided it is proven that the taxpayer did not have an unrestricted right to that amount in a prior year, and therefore the amount should not have been included in income initially),<sup>325</sup> or

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<sup>320</sup> IRS, 2019: 34

<sup>321</sup> Barker & O'Brien, 2010: 425-426

<sup>322</sup> Melone, 2009: 80-81

<sup>323</sup> IRC, 1986: s 1341(a)(2)

<sup>324</sup> Board, 2015: 2-4

<sup>325</sup> IRC, 1986: s 1341(a)(4); Board, 2015: 5 and IRS, 2019: 34-35

- b) Taxable income for the current year excluding the deduction of the amount repaid. This amount of tax will then be reduced by the tax that would have been saved in a prior year relating to the income had it not been disclosed.<sup>326</sup> The result is a tax credit that is available in the year of repayment.<sup>327</sup>

Option b is generally more favorable to the taxpayer, especially in a year when gross income is fairly low, as the taxpayer is able to obtain a refund from the IRS in lieu of the excess taxes paid in a prior year.<sup>328</sup> Melone<sup>329</sup> further indicates that in the year of repayment, if due to rate changes or otherwise more favorable tax benefits arise, the taxpayer is entitled to those benefits and is not constrained to the tax position that would arise had the income initially been excluded.

Where clawbacks are effected through the withholding of future remuneration, the employer discloses the gross amount of remuneration payable to the employee, ignoring the amount withheld. The employee then has the option to claim a deduction for the amount not actually received in terms of ss 162, 165 and 1341,<sup>330</sup> as detailed above.<sup>331</sup> Barker & O'Brien<sup>332</sup> explain that this approach considers the substance of the transaction over its legal form, and is in line with Revenue ruling 79-311.

Where repayments are made on a voluntary basis, the deductions under s 162 and s 165 are not available, unless these repayments are conditional upon the receipt of remuneration from the company in future.<sup>333</sup>

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<sup>326</sup> IRC, 1986: s 1341(a)(5) and Board, 2015: 5

<sup>327</sup> IRS, 2019: 34-35

<sup>328</sup> Board, 2015: 5

<sup>329</sup> Melone, 2009: 94

<sup>330</sup> IRC, 1986: s 162, s 165 and s 1341

<sup>331</sup> Barker & O'Brien, 2010: 426

<sup>332</sup> Barker & O'Brien, 2010: 426

<sup>333</sup> Barker & O'Brien, 2010: 435-436

### 5.6.3 Scenario Three

#### Clawback from former employees

##### 5.6.3(a) - Tax Consequences for the former Employer

Once an employee has retired from the workforce, the employer may recover amounts previously paid out by withholding the amount clawed back from severance or other post termination benefits.<sup>334</sup> Post termination benefits are defined in s 409A<sup>335</sup> as:

'The term "nonqualified deferred compensation plan" means any plan that provides for the deferral of compensation, other than –

(A) a qualified employer plan, and

(B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death'

Furthermore, s 409A<sup>336</sup> states,

'409A(a)(1)(A)(i) - If at any time during a taxable year a nonqualified deferred compensation plan –

(I) fails to meet the requirements of paragraphs (2), (3), and (4), or

(II) is not operated in accordance with such requirements,

all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

...

409A(2)(A) - The requirements of this paragraph are met if the plan provides that compensation deferred under the plan may not be distributed earlier ...

...

409A(3) - The requirements of this paragraph are met if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary.

...

409A(4)(B)(i) - The requirements of this subparagraph are met if the plan provides that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to

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<sup>334</sup> Barker & O'Brien, 2010: 439

<sup>335</sup> IRC, 1986: s 409A other definitions and special rules

<sup>336</sup> IRC, 1986: s 409A

defer such compensation is made not later than the close of the preceding taxable year or at such other time as provided in regulations.

...

409A(4)(C) - ... a subsequent election a delay in a payment or a change in the form of payment –

(i) the plan requires that such election may not take effect until at least 12 months after the date on which the election is made,

(ii) in the case of an election related to a payment not described in clause (ii), (iii), or (vi) of paragraph (2)(A), the plan requires that the payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made ...

...'

In accordance with the above extract, deferred compensation is included in gross income of the employee in the tax year in which a non-forfeitable interest in the income is established. The acceleration of payments to an earlier date or the deferral of payments beyond the period acceptable for deferral contravenes s 409A.<sup>337</sup> The timing of the payment is therefore critical. According to Roberts & Holland,<sup>338</sup> a short-term deferral rule exists. This rule states that where payments of deferred compensation 'actually or constructively' occur within 2.5-months of the earlier of employer's or employees' tax year-end, these payments are not regarded as deferred compensation and are instead included in gross income upon vesting. Bainbridge<sup>339</sup> adds that where the short-term deferral rule applies, the onerous requirements of s 409A need not be adhered to.

Revenue ruling 79-311 stipulates that the employer disclose amounts accruing to the employee on a gross basis each year.<sup>340</sup> If an amount is clawed back from a post termination benefit, the employee will receive the net amount, however the employer discloses the gross amount accruing to the employee each year. In effect, this results in the employee being taxed on the clawed back amount twice, in the year of initial payment and in the year of clawback.<sup>341</sup> The employee may then claim the applicable deductions to recover taxes overpaid in prior years (discussed in detail below).

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<sup>337</sup> Barker & O'Brien, 2010: 439

<sup>338</sup> Roberts & Holland LLP, 2008: 1

<sup>339</sup> Bainbridge, 2016

<sup>340</sup> Barker & O'Brien, 2010: 440

<sup>341</sup> Barker & O'Brien, 2010: 425 and 440

### 5.6.3(b) - Tax Consequences for the Former Executive

Deductions are available to the former executive for the amounts clawed back under ss 162, 165(c)(1) and 1341, identical to those available for existing employees.<sup>342</sup> These business expense deductions are available even though the former employee has completely withdrawn from the workforce. It should be noted that due to the temporary suspension of deductions under ss 162 and 165, no deduction is available for repayments less than \$ 3 000, and repayments in excess of \$3 000 may be deductible under the s 1341 claim of right doctrine provided the criteria have been met.

## 5.7 CASH-BASED PERFORMANCE INCENTIVES

According to Avraam et al.,<sup>343</sup> once services have been rendered by an employee, the employee's right to compensation is established. According to Melone,<sup>344</sup> cash-based incentives usually take the form of a bonus payment or share appreciation rights ('SHARS'). Bonus payments are tied to key performance metrics, the financial metrics of which are critical to warrant a clawback in terms of s 10D or SOX.<sup>345</sup> SHARS on the other hand provide the employee with the cash equivalent of the value of share between the grant and exercise dates.<sup>346</sup> These SHARS are also tied to performance and other financial metrics, and are subject to clawback. They are also beneficial to employers in that no dilution to share capital occurs as no shares are actually issued, and employees benefit from the change in valuation without actually outlaying any amount upfront.<sup>347</sup>

The bonuses and SHARS may be clawed back subsequent to payment if financial results were found to be misrepresented. The amount recouped in accordance with s 10D is the excess amount calculated during the 3-year lookback period, or the full amount of the incentive award if clawed back under SOX.<sup>348</sup> Kesner et al.<sup>349</sup> indicate that any excess amounts paid in error are

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<sup>342</sup> Barker & O'Brien, 2010: 425 and 438

<sup>343</sup> Avraam et al., 2004: 231

<sup>344</sup> Melone, 2009: 95

<sup>345</sup> Melone, 2009: 95

<sup>346</sup> Hayes, 2019

<sup>347</sup> Hayes, 2019

<sup>348</sup> SEC, 2015: 62

<sup>349</sup> Kesner et al., 2015: 6

recovered from current and former executives on a proportional basis. The tax rules detailed above relating to clawback in the same or a subsequent year for current and former employees are also applicable to cash-based performance incentives. As such, the tax implications for the employer and the employee are identical to the narrative included above.

Fried & Shilon<sup>350</sup> suggest that as an alternative to clawing back bonuses, companies may opt to delay the payment of bonuses by banking such amounts and executing payment only once the accuracy of results have been verified. Melone<sup>351</sup> supports this view in that delaying the payment of bonuses allows the employer to make an informed decision considering all facts and circumstances arising subsequently. It also prevents the administrative procedures associated with clawing it back.

## 5.8 PAYROLL TAXES

Payroll taxes are levied in accordance with the doctrine of constructive receipt, irrespective of whether the amount has been earned by the employee or not.<sup>352</sup> The IRS defines this doctrine as follows:

'Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.'<sup>353</sup>

Repp<sup>354</sup> indicates that amounts accruing to employees are included in payroll of the employer. The employer is then responsible to withhold the applicable taxes. Payroll taxes include income tax, withholding tax, unemployment insurance as well as other taxes per the Federal Insurance Contributions Act of 1954 ('FICA') such as social security contributions and medicare taxes.<sup>355</sup> The income tax consequences have been discussed in detail above. If remuneration is paid to an employee and clawed back during the same tax year, the transaction is reversed as if the initial

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<sup>350</sup> Fried & Shilon, 2011a: 725-726

<sup>351</sup> Melone, 2009: 102

<sup>352</sup> Salam & Spyker, 2018: 1

<sup>353</sup> IRS, 1979: s 1451-2(a)

<sup>354</sup> Repp, 2016

<sup>355</sup> Repp, 2016 and Salam & Spyker, 2018: 1

payment did not occur. In the company's tax return, the employer would recover the gross amount paid to the employee, including all applicable taxes.<sup>356</sup> The employee's tax return will not reflect this transaction in its entirety.<sup>357</sup> Repayments are therefore deducted from remuneration on a pre-tax basis.<sup>358</sup>

The claim of right doctrine applies to repayments made in subsequent years. These repayments are accounted for on gross basis, including all applicable taxes.<sup>359</sup> In the year of initial payment, the employer would therefore withhold a larger amount of payroll tax resulting from the overpayment of remuneration. Subsequently in the year of repayment, the employee's taxable income remains unchanged, and the correct amounts of income and other taxes are withheld by the employer. The full amount of the repayment made by the employee is then deducted from the net earnings in accordance with s 1341 of the IRC and Revenue ruling 79-311.<sup>360</sup>

Where an incentive award is clawed back in a subsequent year, the employee may seek recovery of income taxes paid in prior years under the s 1341 claim of right doctrine.<sup>361</sup> It should be noted however, that the claim of right doctrine does not apply to FICA taxes.<sup>362</sup> Instead, s 6413(b) of the IRC<sup>363</sup> applies to the overpayment of such taxes:

'If more than the correct amount of tax ... is paid or deducted with respect to any payment of remuneration ... the amount of the overpayment shall be refunded ...'

The FICA taxes on the amount clawed back may be recovered by the employer directly from the IRS through the submission of an amended tax return according to s 31.6413(a)-1(a) of the Code of Federal Regulations ('CFR').<sup>364</sup> Once the employer recovers such taxes from the IRS, it is obligated to refund the employee these amounts, or alternatively net them off FICA taxes due on

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<sup>356</sup> Salam & Spyker, 2018: 3

<sup>357</sup> Repp, 2016

<sup>358</sup> Salam & Spyker, 2018: 3

<sup>359</sup> Salam & Spyker, 2018: 3

<sup>360</sup> Salam & Spyker, 2018: 4

<sup>361</sup> IRS, 2019: 34

<sup>362</sup> Barker, 2015: 16

<sup>363</sup> IRC, 1986: s 6413(b) and Barker, 2015: 16

<sup>364</sup> IRS, 2011: 417; Repp, 2016 and Barker, 2015: 16

future remuneration payments.<sup>365</sup> Barker & O'Brien<sup>366</sup> indicate that a 3-year window period is provided for the recovery of FICA taxes since the date of original payment.

## 5.9 CLASIFICACION OF PERFORMANCE INCENTIVE AWARDS AS REMUNERATION

'Pay for performance' is a concept used in the USA to motivate employees to perform well. This concept measures output against the job expectations initially set out, and seeks to balance short terms gains with long-term business performance.<sup>367</sup> According to Gibson,<sup>368</sup> companies represent value, and the payments made to employees in lieu of good performance is essentially a distribution of value. Payments made should therefore result from activity that correlates to the company's vision, strategy and purpose.

Deloitte<sup>369</sup> suggests that the concept of 'pay for performance' aims to align the expectations of shareholders with the actual performance of executives. It balances aggressive decision-making with affordability, whilst at the same time it strives to attract new talent.<sup>370</sup> Joseph<sup>371</sup> adds that this approach also allows for flexibility in the workplace as the award is linked to increased productivity, rather than actual time spent on the tasks at hand.

According to the Society for Human Resource Management,<sup>372</sup> incentive awards provide a goal for employees to work towards. Incentive awards encourage focused performance and 'targeted results'.<sup>373</sup> As they serve as a form of compensation for acceptable performance, they are included as part of remuneration. Delta<sup>374</sup> adds that incentive awards are included as part of remuneration and taxed accordingly as this is the general rule adopted by the IRS.

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<sup>365</sup> Barker, 2015: 16 and Salam & Spyker, 2018: 5

<sup>366</sup> Barker & O'Brien, 2010: 441

<sup>367</sup> Heskett, 2007

<sup>368</sup> Gibson, 2015

<sup>369</sup> Deloitte, 2010: 2-3

<sup>370</sup> Deloitte, 2010: 2-3

<sup>371</sup> Joseph, 2017

<sup>372</sup> SHRM, 2018

<sup>373</sup> SHRM, 2018

<sup>374</sup> Delta, 2008: 1

## 5.10 IMPACT OF CLAWBACK ON THE VESTING DATE OF AN AWARD

As indicated above, incentive based compensation is defined in s 10D1(c)(4) as ‘any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure’.<sup>375</sup> Compliance with financial reporting measures are therefore crucial in determining whether or not a clawback should be effected. Other KPI’s such as those linked to time factors, strategic operational factors or any other performance or service-type measure are precluded from this definition.<sup>376</sup>

Furthermore, s 10D(1)(c)(6) specifies that the date of receipt is the earlier of the date on which the award became earned by the executive and the date of actual payment.<sup>377</sup> In addition, the SEC states that an amount has only been ‘earned’ once ‘an executive officer obtains a non-forfeitable interest in a compensatory award’.<sup>378</sup> Where an award is subject to several conditions, all conditions need not be met before the executive obtains a ‘non-forfeitable’ interest in the award.<sup>379</sup> The fulfilment of the financial criteria is sufficient to create an obligation on the part of the company to pay the award and a contingent right on the part of the executive to receive the award.<sup>380</sup> Any other type of non-financial metric or performance criteria is ignored for the purposes of determining whether an executive has a non-forfeitable interest in an award. Once the contingent right to the award is established, the amounts are subject to clawback in accordance with s 10D even if other underlying conditions attached to an award have not been satisfied.<sup>381</sup>

With respect to the SOX clawback, s 304<sup>382</sup> stipulates that an act of misconduct needed to have occurred which resulted from non-compliance with financial reporting regulations to warrant the clawback. Therefore, the trigger event for the enforcement of the clawback is the act of misconduct in defiance of financial regulations.

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<sup>375</sup> SEC, 2015: 41

<sup>376</sup> Bachelder, 2015

<sup>377</sup> SEC, 2015: 53-54 and Bachelder, 2015

<sup>378</sup> SEC, 2015: 53

<sup>379</sup> SEC, 2015: 54

<sup>380</sup> SEC, 2015: 54-55

<sup>381</sup> SEC, 2015: 55

<sup>382</sup> SOX, 2002: s 304(a)

By inference therefore, the inclusion of clawback provisions in executive compensation schemes do not have an impact on the vesting date of the award. The vesting date of the award as indicated above is the earlier of the date on which a non-forfeitable interest is obtained and the date of payment. Both cash and equity awards may have numerous conditions attached to them, of which only the financial conditions need to be met in order to effect the clawback of the award. In substance, the enforceability of the clawback is directly linked to the inaccuracy of financial results, whether or not an act of misconduct has actually occurred.<sup>383</sup>

## 5.11 LEGISLATIVE AND GOVERNANCE CONSIDERATIONS

Studies have found that the inclusion and enforceability of clawback provisions in incentive awards contributes favorably to an effective internal control environment over financial reporting.<sup>384</sup> This in turn boosts investor confidence as it provides quality assurance over the numbers reported.<sup>385</sup>

On the contrary, these clawback provisions may deter the use of judgment in making financial decisions, as the consequences may be grave if an error is subsequently detected. From a project management and investment point of view, executives may opt to abstain from more risky projects where the outcomes are uncertain, in an effort to ensure that financial reporting is correct. As such, decisions may be taken with a view to maximize short-term benefits rather than long-term performance, and this in turn has an adverse operational impact on the business.<sup>386</sup>

The no-fault recovery process of s 10D also incentivizes executives to restructure their remuneration packages, as the risk of clawback remains high even if the executive is not involved in a financial role in the business. As mentioned above, compensation may be clawed back from executives irrespective of whether or not they played a role in the misrepresentation of financial results. Executives may prefer to reduce incentive-based compensation, with the balance being taken in the form of a basic salary or another form of compensation that is not linked to financial

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<sup>383</sup> It should be noted that SOX requires an act of misconduct to have occurred whereas Dodd-Frank does not.

<sup>384</sup> Study conducted by Chan, Chen, Chen and Yu, 2012: 180-196 as stated in SEC, 2015: 115-116

<sup>385</sup> SEC, 2015: 116

<sup>386</sup> SEC, 2015: 118-119

metrics; however this could have adverse consequences for the company.<sup>387</sup> From a taxation point of view, s 162(m)(1) of the IRC<sup>388</sup> limits the company's deduction for the base salaries paid out. This section states,

'In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000.'

According to Delgado, Cvach & Stecher,<sup>389</sup> 'covered employees' in the above extract refer to the CEO and/or CFO and the top three highest earning executives.<sup>390</sup> Therefore, in cases where the base salary of these executives is approaching this ceiling, companies may prefer to structure remuneration packages incorporating an incentive-based component, as it is more tax advantageous to the company. In previous years, performance-based compensation was exempted from the scope of s 162(m); however, this changed by Notice 2018-68 issued by the IRS on 21 August 2018.<sup>391</sup> This notice introduced a grandfathering rule which states that 'compensation paid under a written binding contract that was in effect as of 2 November 2017, may be grandfathered under the old s 162(m) rules, which are more favorable than the new s 162(m) rules, unless and until such contract is materially modified.'<sup>392</sup> Under the new rules of s 162(m), the deduction granted of \$ 1 000 000 applies to total remuneration, which includes performance-based compensation.<sup>393</sup>

In addition to this, reducing performance pay may act as a deterrent from a staff attraction and retention point of view.<sup>394</sup> It may also increase competition amongst employers. Executives may tend to focus more on the accuracy of financial reporting rather than value enhancement in the business. The use of discretionary awards also pose a risk to the company, as these may not be clawed back, thereby resulting in monetary losses in the event of an accounting restatement.<sup>395</sup>

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<sup>387</sup> SEC, 2015: 122-123 and 130

<sup>388</sup> IRC, 1986: s 162(m)(1)

<sup>389</sup> Delgado, Cvach & Stecher, 2018: 2

<sup>390</sup> IRC, 1986: s 162(m)

<sup>391</sup> Delgado, Cvach & Stecher, 2018: 1

<sup>392</sup> Daum, 2018

<sup>393</sup> Delgado, Cvach & Stecher, 2018: 6

<sup>394</sup> SEC, 2015: 129

<sup>395</sup> SEC, 2015: 131-132

Furthermore, Fried & Shilon<sup>396</sup> point out that the payment of amounts to executives in excess of what is required impacts on the value proposition of the company, as value is transferred from the shareholders to the executive. Overpayments to executives also result in smaller sums being available for investment in the business. This could then influence the long-term strategic plan of the business.<sup>397</sup> Other qualitative aspects should also be considered, as the impact on staff morale especially in cases where payments made are not linked to performance. Therefore, effective management and implementation of the clawback is necessary.

Main, Thiess & Wright<sup>398</sup> suggest that delaying the vesting date of executive incentive awards is more beneficial to companies in that the employer would have better control over the amounts in question. The executives would also not be in a position to influence the timing of the payments, and in the process may be encouraged to perform well at all times. This approach would on the one hand reduce the need for employers to clawback amounts paid out in error; but on the contrary, it may also adversely affect staff retention, as compensation packages elsewhere may be more attractive.

According to Pagnattaro & Greene,<sup>399</sup> the existence and implementation of the Dodd-Frank clawback not only improves shareholder confidence in the financial results, but also displays management's commitment to good governance. The SEC<sup>400</sup> explains that from an operational point of view, practical implementation of s 10D may be costly for companies, as amounts clawed back need to be accurately computed. Internal controls need to be operating effectively in an effort to reduce the risk of error. Legal fees may also arise during the recovery process as amounts may be recouped from current or former executives.<sup>401</sup>

Both the SOX and Dodd-Frank clawbacks only apply to publicly listed companies at present. Previously s 5221 of TARP allowed for the clawback of 'any bonus, retention award or incentive compensation' from any company that received TARP funding, irrespective of whether the

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<sup>396</sup> Fried & Shilon, 2011a: 728

<sup>397</sup> Fried & Shilon, 2011a: 728-729

<sup>398</sup> Main, Thiess & Wright, 2010: 4

<sup>399</sup> Pagnattaro & Greene, 2011: 598

<sup>400</sup> SEC, 2015: 135-136

<sup>401</sup> SEC, 2015: 135-136

company was listed or not.<sup>402</sup> From an economic growth and stability point of view, the need to regulate the transactions of listed companies is more important when compared to unlisted companies. From this, the researcher infers that the legislation has stipulated the treatment of clawback in listed companies. It is submitted that these principles could possibly be extended to apply to unlisted companies as well.

## 5.12 SUMMARY

In conclusion, the SOX clawback applies only in cases of misconduct that result in an accounting restatement. The CEO and CFO are penalized whether or not they played a role in the misconduct, and the full amount of the incentive award is subject to clawback. The Dodd-Frank clawback on the other hand allows for amounts paid in excess to be clawed back if originally paid in error. There is no requirement for misconduct to have occurred, and instead any act of non-compliance with financial reporting measures triggers the enforcement of the clawback.

Section 10D provides further detail on the manner of recovery within the three-year lookback period. Clawback may be implemented through the reimbursement of awards by employees to employers; or alternatively employers could enforce the clawback through the withholding of future remuneration. Dodd-Frank allows for excessive amounts to be recovered from existing or former employees. The FICA taxes that are incurred by the employee are not subject to clawback under s 10D. Instead, these are recovered from the IRS directly by the employer and refunded to the employee, or withheld from future remuneration.

Clawback has proven to be an effective mechanism with respect to executive accountability and responsibility in decision-making. In response to the global financial crisis, it served as a remedial measure in curbing the drastic effects of thereof, in addition to being a corrective measure in ensuring that such uncontrolled decision-making does not recur in future. Studies have shown that the use of clawback by companies has also improved investor confidence in financial results as stakeholders are satisfied knowing that executives will be held accountable for their actions.

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<sup>402</sup> Maag, 2018: 364-365

Through the use of the clawback, the importance of an effective internal control environment has been emphasized. Responsible governance is therefore an essential factor in preventing an economic recession.

## **6. CHAPTER FOUR – COMPARATIVE ANALYSIS**

This chapter provides a comparative analysis between the taxation implications in South Africa and the taxation implications in the USA on the following:

**Part A:** The three scenarios detailed in the previous chapter.

**Part B:** Classification of Incentive Awards as Remuneration

**Part C:** The Impact of Clawback on Vesting of an Award

### **6.1 PART A: COMPARISON BETWEEN SA AND USA**

For ease of reference, the three scenarios discussed in the previous chapter have been included below. Note that each example assumes that the grandfathering rule applies to all performance incentives, thereby not contravening s 162(m) of the IRC.

#### **6.1.1 Scenario One**

Payment and clawback within the same tax year (existing employees)

- a. Clawback by repayment
- b. Clawback by withholding future remuneration

#### **6.1.2 Scenario Two**

Payment and clawback in a subsequent tax year (existing employees)

- a. Clawback by repayment
- b. Clawback by withholding future remuneration

### 6.1.3 Scenario Three

#### Clawback from former employees

Each scenario is illustrated through an example and the taxation implications thereof are discussed. The effects of foreign exchange have been ignored and therefore the abbreviation 'CU' has been used to denote currency units.

### 6.1.1 Scenario One

#### Payment and clawback within the same tax year (existing employees)

Director A receives an annual salary of CU 1 000 000, and the financial year-end of the company is 31 December each year. The company, at which Director A is employed, is a listed company. For the financial year ended 31 December 2018, the following key performance indicators were applicable. Director A would receive an award equivalent to 10% of the total annual salary provided he/she displayed effective leadership, which is evidenced through improved client satisfaction and increased market share. In addition, Director A would receive an award of 15% of the total annual salary if revenues grew in excess of 8% and returns on invested capital exceeded that of the prior year by 5%.

Both awards would incorporate a 45% cash component and 55% in equity shares, both of which vest upon receipt. At a board meeting on 31 March 2019, the remuneration committee found that Director A had met all requirements applicable for the 2018 financial year and therefore qualified for both awards. On 30 June 2019, the necessary payments were made to Director A. Subsequently, in August 2019, it was found that returns on invested capital were incorrectly calculated, and the variance in relation to the prior year fell short of the 5% requirement. In addition, a number of client satisfaction surveys were found to be misrepresented. A decision was then made by the board to clawback the award and Director A made the necessary repayments by October 2019.

In the above scenario, Director A receives an award and reimburses the necessary component to the company during the same financial year. The award is received on 30 June 2019 and is reimbursed by October 2019. The tax implications from a SA and USA perspective are discussed below.

### 6.1.1(a) - USA Tax Implications

The Listing Standards for the Recovery of Erroneously Awarded Compensation define ‘incentive based compensation’<sup>403</sup> as follows:

‘For purposes of Section 10D, incentive-based compensation is any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure. Financial reporting measures are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements, any measures that are derived wholly or in part from such measures...’

Furthermore, the SEC indicates that the words ‘in part’ in the above definition imply that awards ‘need not be based solely upon attainment of a financial reporting measure’.<sup>404</sup> Incentive-based compensation excludes salaries, discretionary bonuses, or awards based on performance, operational or other strategic metrics.<sup>405</sup>

In this case, Director A receives an annual salary and two awards in 2019. The annual salary of CU 1 000 000 is excluded from the scope of incentive-based compensation.<sup>406</sup> With regard to the two awards, the first is determined by KPI’s that are dependent upon operational metrics and the second is dependent upon financial metrics. The component of the award that is dependent upon operational metrics is regarded as non-incentive based compensation, and is therefore not subject to clawback under s 10D, whilst the component dependent on financial metrics satisfies the above definition of an incentive award, and is subject to clawback under s 10D.

The amount of the award paid out to Director A on 30 June 2019 is quantified as follows:

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<sup>403</sup> SEC, 2015: 184

<sup>404</sup> SEC, 2015: 41

<sup>405</sup> SEC, 2015: 46 - 47

<sup>406</sup> SEC, 2015: 46

TABLE 1<sup>407</sup>

Description	Operational Metrics:	Financial Metrics:	Total
	Non- Incentive Award	Incentive Award	
Annual Salary	CU 1 000 000	CU 1 000 000	
Applicable Award Rate	10%	15%	
<b>Total Award</b>	<b>CU 100 000</b>	<b>CU 150 000</b>	<b>CU 250 000</b>
Comprising of:			
Cash Component (45%)	CU 45 000	CU 67 500	CU 112 500
Equity Component (55%)	CU 55 000	CU 82 500	CU 137 500

From the above table, Director A receives a total award of CU 250 000 on 30 June 2019, comprising of cash amounting to CU 112 500 and shares amounting to CU 137 500. On this date, the full amount of CU 250 000 constitutes gross income accruing to Director A as defined in s 61(a)<sup>408</sup> of the IRC, which states:

'Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
- (2) Gross income derived from business;
- ...

The company's deduction is however capped at CU 1 000 000 per s 162(m)<sup>409</sup> of the IRC. Under the grandfathering rule, performance incentives are exempt from this limitation.<sup>410</sup>

In August 2019, a decision was made to clawback the award with the necessary repayments being made in October 2019. As indicated in the previous chapter, clawback may be carried out

<sup>407</sup> Author's own compilation

<sup>408</sup> IRC, 1986: s 61(a)

<sup>409</sup> IRC, 1986: s 162(m)

<sup>410</sup> Daum, 2018

through s 304 of SOX or through s 10D of the SEC. The application of the SOX clawback requires an act of misconduct to have occurred.<sup>411</sup> In addition to this, the SEC initiates the process to clawback the amounts previously paid out, and not the board of directors. In this case, the board of directors determines that awards should be clawed back. The SEC has not initiated any procedures to recover the amounts from Director A, and neither is there evidence indicating that the reasons for clawback amount to misconduct. For this reason, the SOX clawback is not applicable in this scenario.

Section 10D on the other hand applies irrespective of whether an act of misconduct has occurred. This clawback also only applies in cases where financial reporting metrics have not been adhered to. In this scenario, the return on investment ratio fell short of the requirements and client satisfaction surveys were found to be misrepresented. Only the return on investment ratio represents a financial metric and is therefore subject to clawback under s 10D. Director A would therefore be required to return an amount of CU 150 000 in October 2019.

As the payment of the award and the clawback occurred within the same financial year, Revenue Ruling 79-311 applies. This ruling states that amounts refunded by the employee to the employer are excluded from the gross income of the employee. The amount received by the employer is also included in the company's gross income, thereby eliminating the deduction previously claimed. Director A is also liable for FICA taxes on the award of CU 100 000 received at year-end. These taxes will be withheld by the company accordingly.

The total taxation effect for 2019 is as follows:

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<sup>411</sup> SOX, 2002: s 304(a)

TABLE 2<sup>412</sup>

Description	Applicable Rates	Amounts
<b>Salary</b>		<b>CU 1 000 000</b>
Awards Granted		CU 250 000
Clawback		(CU 150 000)
<b>Awards Retained</b>		<b>CU 100 000</b>
<b>Total Remuneration</b>		<b>CU1 100 000</b>
<b>Income Tax</b> <sup>413</sup>	<b>37%</b>	<b>(CU 371 988) (a)</b>
<b>FICA Tax Rates</b> <sup>414</sup>	<b>7.65%</b>	<b>(CU 84 150) (b)</b>
- Medicare	1.45%	(CU 15 950) (c)
- Social Taxes	6.2%	(CU 68 200) (d)
<b>Net Amount</b>		<b>CU 643 862</b>

Calculations:

$$(a) \text{ CU } 1\,100\,000 - \text{CU } 510\,300 = \text{CU } 589\,700 * 37\% = \text{CU } 218\,189 + \text{CU } 153\,798.5 \\ = \text{CU } 371\,988$$

$$(b) \text{ CU } 1\,100\,000 * 7.65\% = \text{CU } 84\,150$$

$$(c) \text{ CU } 1\,100\,000 * 1.45\% = \text{CU } 15\,950$$

$$(d) \text{ CU } 1\,100\,000 * 6.2\% = \text{CU } 68\,200$$

Extract from tax 2019 income tax tables:

2019 <sup>415</sup>	\$ 510 301 or more	\$ 153 798.50 plus 37% of the amount above \$ 510 300
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If Director A did not refund the award and instead the company withheld the amount from the November and December 2019 salary payments, the overall tax effect for 2019 would be the same as that illustrated above.

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<sup>412</sup> Author's own compilation

<sup>413</sup> Orem, 2019

<sup>414</sup> ADP, 2018: 1

<sup>415</sup> Orem, 2019

### 6.1.1(b) - SA Tax Implications

From a SA tax point of view, there is no differentiation in the tax treatment between awards based on financial and non-financial metrics. In this case, a component of the award is received in cash and the remainder is in the form of shares, each of which have different tax implications.

Gross income as defined in s1<sup>416</sup> includes:

' ...

- (c) any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount (other than an amount referred to in section 8 (1), 8B or 8C) received or accrued in respect of any employment or the holding of any office;

....'

With respect to the cash awards, the full amount of CU 112 500 is included in gross income of Director A as it was earned in lieu of services rendered to the employer. The scenario does not specify any expenditure incurred by Director A in earning this income, hence the deductions of s 11(a), s 23(m) and s 23H are not applicable.

The equity share awards on the other hand do not satisfy the definition of gross income. Instead, s 8C is applicable. Section 8C distinguishes between restricted and unrestricted equity instruments. Restricted equity instruments are subject to certain conditions, the fulfilment of which impact on the timing of the taxable event. Unrestricted equity instruments vest upon acquisition and allow the recipient to freely dispose of the instrument at any time. In this scenario, Director A has to meet certain requirements in order to qualify for the award; hence, the equity shares represent restricted equity instruments.

According to this scenario, these awards vest upon receipt, and therefore in June 2019, the gains per s 8C are triggered. Furthermore, s 8C(2)(a)<sup>417</sup> specifies that the gain is calculated as the difference between the market value of the equity instrument on the date of vesting less any consideration initially paid. As indicated above, Director A did not pay any initial consideration for

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<sup>416</sup> ITA, 1962: s 1

<sup>417</sup> ITA, 1962: s 8C(2)(a)

the equity shares; hence, the full amount received upon vesting is the taxable gain per s 8C. Section 8C gains are included in gross income of Director A as defined in s 1<sup>418</sup> of the ITA.

According to the Fourth Schedule,<sup>419</sup> employees' tax is calculated on remuneration paid to an employee by the company and paid over to SARS directly in the form of PAYE. This tax in substance represents the income tax due on the amounts received. Employees' tax is calculated based on annualized regular and irregular income, and is paid to SARS by the company each month.<sup>420</sup> In June 2019, Director A receives the awards, hence the taxation on the amounts become due. Subsequently in October 2019, when the amounts are repaid, Director A is entitled to S 11(nA)<sup>421</sup> deduction on the amounts refunded. The annualized regular income of Director A does however remain the same, hence the PAYE paid over to SARS does not change. Director A has now incurred the taxes with respect to the awards initially received, but does not recover the taxes paid on such awards. At the end of the year of assessment, Director A may receive a refund from SARS for the overpayment of income tax.

As illustrated above, the awards comprise of a total cash component of CU 112 500 and an equity component of CU 137 500. The employer is entitled to deduct the full amount of CU 112 500 as an expense incurred in the course of trade under s 11(a)<sup>422</sup> which states:

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

With respect to the equity component of CU 137 500, the ITA does not specify whether the company may deduct this portion under s 11(a) as expenditure incurred in the course of trade. An analysis of the underlying intention behind the award is necessary to determine if this was for revenue or capital purposes. Section 8C is also silent on this. Currently in the USA, employers are allowed this deduction under s 162(m) provided all requirements have been met. Similarly, s 11(lA)<sup>423</sup> of the ITA provides employers for a deduction for s 8B awards. It is submitted therefore

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<sup>418</sup> ITA, 1962: s 1

<sup>419</sup> ITA, 1962: Fourth Schedule

<sup>420</sup> Simple Pay, n.d.

<sup>421</sup> ITA, 1962: s 11(nA)

<sup>422</sup> ITA, 1962: s 11(a)

<sup>423</sup> ITA, 1962: s 11(lA)

that a deduction be allowed to companies for equity awards granted to employees for revenue purposes.

The taxation consequences for 2019 are as follows:

TABLE 3<sup>424</sup>

Description	Cash Component (45%)	Equity Component (55%)	Total
Annual Salary			<b>CU 1 000 000</b>
Awards			
- Operational Metrics (10%)	CU 45 000	CU 55 000	CU 100 000
- Financial Metrics (15%)	CU 67 500	CU 82 500	CU 150 000
<b>Total Awards</b>	<b>CU 112 500</b>	<b>CU 137 500</b>	<b>CU 250 000</b>
Clawback	(CU 112 500)	(CU 137 500)	(CU 250 000)
<b>Total Remuneration</b>	-	-	<b>CU 1 000 000</b>
<b>Income Tax at 41%</b> <sup>425</sup>			<b>(CU 429 541)</b>
- Annualised Regular Income			(CU 327 041) (a)
- Annualised Irregular Income			(CU 102 500) (b)
<b>Other Employment Taxes</b>			<b>(CU 30 000)</b>
- SDL at 1%			(CU 10 000) (c)
- UIF at 2%			(CU 20 000) (d)
<b>Net Amount</b>			<b>CU 540 459</b>

### Calculations

<sup>424</sup> Author's own compilation

<sup>425</sup> SARS, 2019b and ITA, 1962: Fourth Schedule

According to the 2019/2020 tax tables,<sup>426</sup> the following rates apply to individuals:

<b>Tax Bracket</b>	<b>Tax Rates</b>
708 311 – 1 500 000	207 448 + 41% of taxable income above 708 310

(a) Tax on Annualised Regular Income:

$$\text{CU } 1\,000\,000 - \text{CU } 708\,310 = \text{CU } 291\,690 * 41\% = \text{CU } 119\,593 + \text{CU } 207\,448 \\ = \text{CU } 327\,041$$

(b) Tax on Annualised Irregular Income:

$$\text{Projected Total Remuneration} = \text{CU } 1\,000\,000 + \text{CU } 250\,000 = \text{CU } 1\,250\,000$$

Tax on projected remuneration:

$$\text{CU } 1\,250\,000 - \text{CU } 708\,310 = \text{CU } 541\,690 * 41\% = \text{CU } 222\,093 + \text{CU } 207\,448 \\ = \text{CU } 429\,541$$

$$\text{Tax on awards} = \text{CU } 429\,541 - \text{CU } 327\,041 \text{ (a)} = \text{CU } 102\,500$$

(c) SDL at 1% (payable by the employer):

$$\text{CU } 1\,000\,000 * 1\% = \text{CU } 10\,000 \text{ payable proportionately each month}$$

(d) UIF at 2% (incorporating 1% each for the employer and employee):

$$\text{CU } 1\,000\,000 * 2\% = \text{CU } 20\,000 \text{ payable proportionately each month}$$

The table above shows that Director A pays the taxation on the annual salary received as well as the cash and equity awards. Director A also pays the required SDL and UIF each month, which are withheld by the company and paid directly to SARS. Subsequent to clawback, Director A does not recover the overpayment in taxes immediately. This amount is only recoverable from SARS at the end of the year of assessment in February 2020 when an individual tax return is submitted. In substance therefore, it is as though Director A never received the awards, and did not incur any taxes with respect to these awards.

<sup>426</sup> Bankrate, 2019 and SARS, 2019b

According to Wessels,<sup>427</sup> the BCEA stipulates that in addition to the ordinary statutory deductions, companies are only allowed to make deductions from future salary payments if agreed to in writing by the employee. In line with this requirement, if Director A did not effect the repayment, the company could only make a deduction from future remuneration payments if there was a prior written agreement in place. Assuming the agreement was in place and the clawback was effected through a future remuneration deduction, the tax implications would be the same as that illustrated above. The PAYE on annualised regular income, as well as the SDL and UIF would reduce during the remaining months of the year to compensate for the lower remuneration earned. At the end of the tax year, any remaining overpayment in taxes would then be refunded directly to Director A by SARS.

In essence, this approach is similar to that adopted by the USA; however, clawback through repayment is currently the only option available to companies to recover amounts paid to employees, unless written agreements are in place authorizing deductions from future remuneration. It is crucial for all policies and procedures to be clearly documented to prevent additional legal costs arising upon execution of the clawback.

### **6.1.2 Scenario Two**

#### Payment and clawback in a subsequent tax year (existing employees)

Director A was employed by a listed company on 1 January 2013, and the financial year-end of the company is 31 December each year. The financial records for the year-ended 31 December 2019 are currently under review. Key performance indicators since 2016 are illustrated in the table below:

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<sup>427</sup> Wessels, 2018

TABLE 4<sup>428</sup>

	31 December 2016	31 December 2017	31 December 2018
Annual Salary	CU 1 000 000	CU 1 100 000	CU 1 200 000
<b>Key Performance Indicators</b>			
Net Income exceeds CU 1 500 000	15%	13%	11%
Net Income between CU 1 000 000 – CU 1 500 000	12%	10%	9%
Net Income between CU 800 000 – CU 1 000 000	8%	7%	6%
Net Income below CU 800 000	Nil	Nil	Nil
Service Award payable after 4 years	5%	N/A	N/A

According to the company's policies, if financial metrics are satisfied, bonuses are payable in equity instruments, whilst the service award is payable in cash. Bonuses are calculated as a percentage of the annual salary and are paid out on 30 March of the following year. Bonuses paid in the form of equity instruments are deemed to be at market value for which Director A paid no initial consideration. Service awards are paid out every 4-years provided Director A performs well in each year. Each year, 75% of Director A's annual salary is taken in cash, with the remainder taken in the form of other long-term incentives including a provident fund and retirement annuity.<sup>429</sup> All awards vest on the date of receipt.

As at 31 December 2016, Director A was in the employ of the company for 4 years and therefore qualified for the service award. The annual results for 2016 also displayed net income of CU 1 580 000. Consequently, Director A qualified for a 15% bonus in addition to the service award. In 2017, net income amounted to CU 1 200 000, and this dropped further in 2018 to CU 960 000. Due to deteriorating performance each year, the board decided to scrutinize the financial results of the company.

<sup>428</sup> Author's own compilation

<sup>429</sup> This ensures that s 162(m) of the IRC is not contravened. The tax treatment of other long-term incentives is out of the scope of this study. For the purposes of this example, the tax implications on long-term incentives is assumed to be the same as that on the cash salary component.

It was found that expenses had been understated each year resulting in an inflated amount of net income being disclosed. The understatement of expenditure resulted from the incorrect percentages being applied in estimating the fair value of certain items. Net income, after applying the correct thresholds to expenditure was found to be CU 1 325 000 for 2016, CU 980 000 for 2017 and CU 730 000 for 2018. This oversight error did however have a material impact and an accounting restatement was required on 31 December 2019. In light of this, the board of directors concluded that no bonuses would be paid out in 2019. In addition, all excessive amounts previously paid out to Director A will be clawed back. Director A received a salary for 2019 amounting to CU 1 200 000.

The table below summarizes net income as reported between 2016 - 2018:

TABLE 5<sup>430</sup>

<b>Net income</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
Reported	CU 1 580 000	CU 1 200 000	CU 960 000
Corrected	CU 1 325 000	CU 980 000	CU 730 000

The following table shows the value of the bonuses received by Director A each year. A discussion on the tax consequences ensues thereafter.

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<sup>430</sup> Author's own compilation

TABLE 6<sup>431</sup>

Description	31 December 2016		31 December 2017		31 December 2018		Total
Annual Salary	CU 1 000 000		CU 1 100 000		CU 1 200 000		CU 3 300 000
<b>Bonuses Received by Director A</b>							
Reported Indicators							
Service Award	5%	CU 50 000	N/A	N/A	N/A	N/A	CU 50 000
Financial Award	15%	CU 150 000	10%	CU 110 000	6%	CU 72 000	CU 332 000
<b>Total</b>	<b>CU 200 000</b>		<b>CU 110 000</b>		<b>CU 72 000</b>		<b>CU 382 000</b>
Corrected Indicators							
Service Award	5%	CU 50 000	N/A	N/A	N/A	N/A	CU 50 000
Financial Award	12%	CU 120 000	7%	CU 77 000	0%	Nil	CU 197 000
<b>Total</b>	<b>CU 170 000</b>		<b>CU 77 000</b>		<b>CU -</b>		<b>CU 247 000</b>
<b>Difference Attributable to Excessive Bonuses<sup>432</sup></b>							
Service Award	Nil		Nil		Nil		
Financial Award	<b>CU 30 000</b>		<b>CU 33 000</b>		<b>CU 72 000</b>		<b>CU 135 000</b>

### 6.1.2(a) - USA Tax Implications

#### 6.1.2(a)(i) - Service Award

Director A receives the service award in cash on 31 December 2016. In order to qualify for this award, Director A had to render 4-years of service to the company. This award has no link to any financial metric, and therefore in subsequent years would not be subject to the s 10D clawback. The tax treatment of this award is the same as that for performance awards described in scenario

<sup>431</sup> Author's own compilation

<sup>432</sup> Difference arising on bonuses calculated using reported indicators vs corrected indicators.

1 above. Director A includes the CU 50 000 received in gross income in accordance with s 61(a)<sup>433</sup> of the IRC. As this amount constitutes remuneration, the company also qualifies for a deduction accordingly.

### **6.1.2(a)(ii) - Financial Award**

In 2016, 2017 and 2018, Director A met the required financial metrics and was therefore paid out a bonus in equity instruments amounting to CU 332 000 in total. As discussed in scenario 1 above, only awards that are dependent on financial metrics qualify as incentive-based compensation under s 10D(1)(c)(4).<sup>434</sup> According to s 10D(1)(c)(6),<sup>435</sup> the awards are deemed to be received in the financial period in which the financial metrics have been satisfied. Therefore on 31 December 2016, the bonus of CU 150 000 received by Director A becomes subject to clawback under s 10D. The same principle applies to the bonuses received by Director A on 31 December 2017 and 2018 amounting to CU 110 000 and CU 72 000 respectively. These awards also constitute remuneration and therefore Director A is required to include the amounts received in gross income each year per s 61(a),<sup>436</sup> whilst the company gets a corresponding deduction for the payment made in lieu of services rendered.

Section 10D<sup>437</sup> stipulates that incentive awards should be earned by the recipient prior to receipt, and awards are deemed to be earned once the recipient has a non-forfeitable interest in the award. The satisfaction of financial criteria create the non-forfeitable interest as a contingent right exists for the recipient to receive the award.<sup>438</sup> Therefore, each year, once Director A has met the net income requirements, he becomes entitled to the award in accordance with s 10D. Once the award is deemed to be received, the criteria are satisfied to claw it back.<sup>439</sup>

The board of directors subsequently found that net income had been overstated and an accounting restatement was required on 31 December 2019. A decision to clawback awards previously paid out was also taken. It should be noted that in this scenario, the overstatement of

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<sup>433</sup> IRC, 1986: s 61(a)

<sup>434</sup> SEC, 2015: 41

<sup>435</sup> SEC, 2015: 53-54

<sup>436</sup> IRC, 1986: s 61(a)

<sup>437</sup> SEC, 2015: 41

<sup>438</sup> SEC, 2015: 54-55

<sup>439</sup> SEC, 2015: 53-54

net income was not classified as an act of misconduct, hence a clawback under s 304 of SOX would not apply. In addition, the SEC plays no role in identifying the error and recovering the amounts paid out to Director A. Section 10D therefore applies.

Section 10D(b)(2)<sup>440</sup> indicates,

'... the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.'

When an accounting restatement is required, s 10D specifies that for 3-years prior to the date of restatement, incentive-based compensation should be recalculated using the corrected figures as if they were initially used; and deduct this value from the incentive-based compensation actually paid out during this period. The difference represents an excessive amount paid out in error which should be recouped.

In this case, the accounting restatement was required on 31 December 2019; hence, the lookback period commences 3-years prior to that on 31 December 2016. The table below recomputes the value Director A should have received during the 3-year lookback period and compares it the value actually received. The difference is clawed back in December 2019.

Table reflecting the tax consequences for Director A from 31 December 2016 – 31 December 2018.

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<sup>440</sup> SEA, 1934: s 10D(b)(2)

TABLE 7<sup>441</sup>

Description	2016	2017	2018	Total
<b>Tax Consequences on Annual Salary</b>				
Annual Salary	CU 1 000 000	CU 1 100 000	CU 1 200 000	<b>CU 3 300 000</b>
Income Tax	(CU 352 170) (a)	(CU 391 419) (b)	(CU 409 690) (c)	<b>(CU 1 153 279)</b>
<b>Tax Consequences on Bonuses Calculated using Reported Indicators (A)</b>				
Service Award	CU 50 000	Nil	Nil	<b>CU 50 000</b>
Financial Award	CU 150 000	CU 110 000	CU 72 000	<b>CU 332 000</b>
<b>Total (A)</b>	<b>CU 200 000</b>	<b>CU 110 000</b>	<b>CU 72 000</b>	<b>CU 382 000</b>
Income Tax (C)	(CU 79 200) (a)	(CU 43 560) (b)	(CU 26 640) (c)	<b>(CU 149 400)</b>
<b>Tax Consequences on Bonuses Calculated using Corrected Indicators (B)</b>				
Service Award	CU 50 000	Nil	Nil	<b>CU 50 000</b>
Financial Award	CU 120 000	CU 77 000	Nil	<b>CU 197 000</b>
<b>Total (B)</b>	<b>CU 170 000</b>	<b>CU 77 000</b>	<b>Nil</b>	<b>CU 247 000</b>
Income Tax (D)	(CU 67 320) (a)	(CU 30 492) (b)	Nil	<b>(CU 97 812)</b>
<b>Bonus and Taxation Paid in Excess</b>				
Excessive Bonus (A – B)	CU 30 000	CU 33 000	CU 72 000	<b>CU 135 000</b>
Income Tax (C – D)	(CU 11 880)	(CU 13 068)	(CU 26 640)	<b>(CU 51 588)</b>

Calculations:

(a) Tax on Salary:  $CU\ 1\ 000\ 000 - CU\ 415\ 050 = CU\ 584\ 950 * 39.6\% = CU\ 231\ 640.2$   
 $+ CU\ 120\ 529.75 = CU\ 352\ 170$

Tax on Bonus using Reported Indicators:  $CU\ 200\ 000 * 39.6\% = CU\ 79\ 200$

Tax on Bonus using Corrected Indicators:  $CU\ 170\ 000 * 39.6\% = CU\ 67\ 320$

(b) Tax on Salary:  $CU\ 1\ 100\ 000 - CU\ 418\ 400 = CU\ 681\ 600 * 39.6\% = CU\ 269\ 913.6$   
 $+ CU\ 121\ 505.25 = CU\ 391\ 419$

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<sup>441</sup> Author's own compilation

Tax on Bonus using Reported Indicators: CU 110 000 \* 39.6% = CU 43 560

Tax on Bonus using Corrected Indicators: CU 77 000 \* 39.6% = CU 30 492

(c) Tax on Salary: CU 1 200 000 – CU 500 000 = CU 700 000 \* 37% = CU 259 000  
+ CU 150 689.5 = CU 409 690

Tax on Bonus using Reported Indicators: CU 72 000 \* 37% = CU 26 640

Tax on Bonus using Corrected Indicators: CU 0 \* 37% = CU 0

An extract from the tax tables applicable to each year are included below:

2016 <sup>442</sup>	\$ 415 051 or more	\$ 120 529.75 plus 39.6% of the amount above \$415 050
2017 <sup>443</sup>	\$ 418 401 or more	\$ 121 505.25 plus 39.6% of the amount above \$ 418 400
2018 <sup>444</sup>	\$ 500 001 or more	\$ 150 689.50 plus 37% of the amount above \$ 500 000
2019 <sup>445</sup>	\$ 510 301 or more	\$ 153 798.50 plus 37% of the amount above \$ 510 300

In accordance with the calculations shown in the table above, Director A received a total of CU 332 000 during the 3-year lookback period (2016 – 2018), yet he should only have received CU 247 000 had net income been correctly disclosed. The difference amounts to CU 135 000 which is subject to clawback under s 10D. Section 10D(1)(b)(1)(iii)<sup>446</sup> further states that a clawback should be effected on a gross basis. Director A should therefore repay the full amount of CU 135 000, ignoring any taxes already paid on this amount.

In each year, the company discloses to the IRS the full amount of remuneration paid out to Director A. This includes the annual salary, as well as the service and financial awards. In 2019, the company still discloses the total remuneration paid out to Director A amounting to CU 1 200 000, excluding the CU 135 000 recouped. The same principle would apply had Director

<sup>442</sup> Phillips, 2015

<sup>443</sup> Phillips, 2016

<sup>444</sup> Phillips, 2018

<sup>445</sup> Orem, 2019

<sup>446</sup> SEC, 2015: 61

not refunded the amount and instead opted for a deduction from future payments. In the company's accounting records, each year the remuneration paid out is deducted as a business expense, and in 2019, the reimbursement of CU 135 000 is included in the company's gross income in accordance with the tax benefit rule.<sup>447</sup>

Director A on the other hand cannot amend tax returns submitted in prior years. In order to recover taxes overpaid on the erroneous amount received, Director A would seek relief under the claim of right doctrine.<sup>448</sup> This doctrine stipulates 3 criteria, namely:

**i) An unrestricted right to income exists**

In each respective year, Director A applied the incorrect percentages in determining fair value that resulted in an understatement to expenditure. This was merely due to oversight, and was unintentional. Director A also received a service award in 2016 thereby implying that Director A satisfies requirements and performs well. At each year-end, it is presumed that Director A believed that the correct percentages were applied, thereby creating an apparent right to the bonus. An apparent right is sufficient in creating an unrestricted right to income per s 1341. Consequently, the amounts received by Director A are included in gross income in each year.

**ii) Deductions are allowed if no unrestricted right is found to exist in subsequent year**

In 2019, it was determined that expenditure was understated between 2016 – 2018. This resulted in an overstatement in net income, which in turn resulted in Director A receiving a bonus in excess of what should have been received each year. During 2016, 2017 and 2018, this fact was unknown and an apparent right to the bonus existed in these years, however in 2019, it is subsequently determined that the thresholds were incorrect and that net income was overstated. There is also a direct link between the gross income inclusion in each year and the clawback in 2019. In addition to this, the thresholds applied in determining fair value did not arise subsequently. They were available during each year, but were overlooked resulting in the error. Therefore, an unrestricted right to the excessive portion of the bonus (CU 135 000) does not exist. This amount is therefore deductible from

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<sup>447</sup> IRC, 1986: s 111(a)

<sup>448</sup> IRC, 1986: s 1341

gross income as it was initially included in prior years.

**iii) Aggregate amount exceeds \$ 3 000**

In this case, the portion paid out in excess amounts to CU 135 000.

As the requirements for 1341 are satisfied, in 2019 Director A will choose the more favorable of the following two options:

**TABLE 8<sup>449</sup>**

<b>2019</b>		
<b>Description</b>	<b>Option 1 (Includes Clawback)</b>	<b>Option 2 (Excludes Clawback)</b>
Annual Salary	CU 1 200 000	CU 1 200 000
Clawback	(CU 135 000)	Nil
<b>Net Taxable Income</b>	<b>CU 1 065 000</b>	<b>CU 1 200 000</b>
Income Tax for 2019 <sup>450</sup>	(CU 359 038) (a)	(CU 408 988) (b)
Tax Saving from 2016 - 2018	Nil	CU 51 588 (c)
<b>FICA Taxes<sup>451</sup> (7.65%)</b>	<b>(CU 91 800) (d)</b>	<b>(CU 91 800) (d)</b>
- Medicare (1.45%)	(CU 17 400) (e)	(CU 17 400) (e)
- Social Taxes (6.2%)	(CU 74 000) (f)	(CU 74 000) (f)
<b>Net Income for 2019</b>	<b>CU 614 162</b>	<b>CU 647 624</b>

**Calculations:**

$$(a) \text{ CU } 1\,065\,000 - \text{CU } 510\,300 = \text{CU } 554\,700 * 37\% = \text{CU } 205\,239 + \text{CU } 153\,798.5 \\ = \text{CU } 359\,038$$

$$(b) \text{ CU } 1\,200\,000 - \text{CU } 510\,300 = \text{CU } 689\,700 * 37\% = \text{CU } 255\,189 + \text{CU } 153\,798.5 \\ = \text{CU } 408\,988$$

(c) Amount calculated in table 8 above

<sup>449</sup> Author's own compilation

<sup>450</sup> Orem, 2019

<sup>451</sup> ADP, 2018: 1

(d) Option 1 & 2: CU 1 200 000 \* 7.65% = CU 91 800

(e) Option 1 & 2: CU 1 200 000 \* 1.45% = CU 17 400

(f) Option 1 & 2: CU 1 200 000 \* 6.2% = CU 74 000

As shown above, option 2 is more favorable Director A. Director A also benefits from the reduction in tax rates between 2016 and 2019. The claim of right doctrine is not applicable to FICA taxes. Director A therefore pays FICA taxes on the full amount of remuneration received in 2019, excluding the amount clawed back. The overpayment in FICA taxes in prior years will be recovered by the company directly from the IRS and refunded to Director A. Alternatively it may be withheld from future remuneration payments.<sup>452</sup> If the clawback is implemented through withholding of future remuneration payments, the tax consequences would be the same option A in the table above. The taxable income would reduce, resulting in lower income tax each month, and the FICA taxes will still be calculated on gross remuneration excluding the clawback.

## **6.1.2(b) - SA Tax Implications**

### **6.1.2(b)(i) - Service Award**

From a South African perspective, Director A receives the service award of CU 50 000 after 4-years of satisfactory service. The tax implications of this cash bonus are identical to that in scenario 1 detailed above.

Director A therefore includes the cash bonus of CU 50 000 in gross income on 31 December 2016. Mention has not been made of any expenditure incurred by Director A in earning this income, hence the deductions of s 11(a), s 23(m) and s 23H are not applicable. The company, on the other hand is entitled to deduct the full amount of CU 50 000 as an expense incurred in the course of trade under s 11(a)<sup>453</sup> in the 2016 financial year.

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<sup>452</sup> IRC, 1986: s 6413(b)

<sup>453</sup> ITA, 1962: s 11(a)

### 6.1.2(b)(ii) - Financial Award

The tax treatment of equity instruments are governed by s 8C<sup>454</sup> of the ITA. As indicated in scenario 1 above, s 8C differentiates between restricted and unrestricted equity instruments. According to s 8C(7),<sup>455</sup> these awards are classified as restricted equity instruments, as certain conditions needed to be met before Director A became eligible to receive the award. Director A only qualifies for these awards each year if net income exceeds a predetermined percentage threshold. If the minimum thresholds are not satisfied, Director A does not receive any award.

Additionally, these awards only vest upon receipt. According to Interpretation Note 55,<sup>456</sup> any gain or loss arising on the vesting of an equity instrument is included in income in the year of vesting. On 31 December 2016, 2017 and 2018, Director A calculates the gain or loss made on the equity instrument in accordance with s 8C(2)(a)<sup>457</sup> as the difference between the market value on that date and any consideration initially paid. In this scenario, Director A did not pay any initial consideration for the equity instruments received; hence, the total market value of the instrument constitutes the gain per s 8C, and is included in gross income accordingly. The tax treatment of the equity instruments in this scenario is the same as that described in scenario 1 above.

Remuneration has been defined in the Fourth Schedule<sup>458</sup> as follows:

‘Remuneration means any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered, including –

...  
(e) any amount referred to in section 8C which is required to be included in the income of that person;

...’

In line with this definition, the gains arising on the vesting of the equity instruments constitute remuneration for Director A. Employees’ tax is therefore calculated based on annualized regular and irregular income, and is paid to SARS by the company each month in the form of PAYE.<sup>459</sup>

<sup>454</sup> ITA, 1962: s 8C

<sup>455</sup> ITA, 1962: s 8C(7)

<sup>456</sup> SARS, 2011: 1

<sup>457</sup> ITA, 1962: s 8C(2)(a)

<sup>458</sup> ITA, 1962: Fourth Schedule

<sup>459</sup> Simple Pay, n.d.

The taxation implications of the salary, cash bonus and the equity instruments received by Director A in each year are as follows:

TABLE 9<sup>460</sup>

<b>Description</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
<b>Annual Salary</b>	<b>CU 1 000 000</b>	<b>CU 1 100 000</b>	<b>CU 1 200 000</b>	<b>CU 1 200 000</b>
Awards based on Reported Indicators				
- Cash Award	CU 50 000	Nil	Nil	Nil
- Equity Award	CU 150 000	CU 110 000	CU 72 000	Nil
<b>Total Awards</b>	<b>CU 200 000</b>	<b>CU 110 000</b>	<b>CU 72 000</b>	<b>Nil</b>
<b>Total Remuneration</b>	<b>CU 1 200 000</b>	<b>CU 1 210 000</b>	<b>CU 1 272 000</b>	<b>CU 1 200 000</b>
<b>Income Tax/ PAYE</b>	<b>(CU 413 054)</b>	<b>(CU 415 531)</b>	<b>(CU 440 145)</b>	<b>(CU 409 041)</b>
- Annualised Regular Income (a)	(CU 331 054)	(CU 370 431)	(CU 410 625)	(CU 409 041)
- Annualised Irregular Income (b)	(CU 82 000)	(CU 45 100)	(CU 29 520)	Nil
<b>Other Employment Taxes</b>	<b>(CU 30 000)</b>	<b>(CU 33 000)</b>	<b>(CU 36 000)</b>	<b>(CU 36 000)</b>
- SDL at 1% (c)	(CU 10 000)	(CU 11 000)	(CU 12 000)	(CU 12 000)
- UIF at 2% (d)	(CU 20 000)	(CU 22 000)	(CU 24 000)	(CU 24 000)
<b>Net Amount</b>	<b>CU 756 946</b>	<b>CU 761 469</b>	<b>CU 795 855</b>	<b>CU 754 959</b>

According to SARS,<sup>461</sup> the following rates applied to individuals in each respective year:

<sup>460</sup> Author's own compilation

<sup>461</sup> SARS, 2019b

Year	Taxable Income	Tax Rates
2019	708 311 – 1 500 000	207 448 + 41% of taxable income above 708 310
2018	708 311 – 1 500 000	209 032 + 41% of taxable income above 708 310
2017	701 301 and above	206 964 + 41% of taxable income above 701 300
2016	701 301 and above	208 587 + 41% of the amount above 701 300

### Calculations

(a) Tax on Annualised Regular Income:

**2016:** CU 1 000 000 – CU 701 300 = CU 298 700 \* 41% = CU 122 467 + CU 208 587  
= CU 331 054

**2017:** CU 1 100 000 – CU 701 300 = CU 398 700 \* 41% = CU 163 467 + CU 206 964  
= CU 370 431

**2018:** CU 1 200 000 – CU 708 310 = CU 491 690 \* 41% = CU 201 593 + CU 209 032  
= CU 410 625

**2019:** CU 1 200 000 – CU 708 310 = CU 491 690 \* 41% = CU 201 593 + CU 207 448  
= CU 409 041

(b) Tax on Annualised Irregular Income:

**2016:** Projected Total Remuneration = CU 1 000 000 + CU 200 000 = CU 1 200 000

Tax on projected remuneration:

CU 1 200 000 – CU 701 300 = CU 498 700 \* 41% = CU 204 467 + CU 208 587  
= CU 413 054

Tax on awards = CU 413 054 – CU 331 054 (a) = CU 82 000

**2017:** Projected Total Remuneration = CU 1 100 000 + CU 110 000 = CU 1 210 000

Tax on projected remuneration:

CU 1 210 000 – CU 701 300 = CU 508 700 \* 41% = CU 208 567 + CU 206 964  
= CU 415 531

Tax on awards = CU 415 531 – CU 370 431 (a) = CU 45 100

**2018:** Projected Total Remuneration = CU 1 200 000 + CU 72 000 = CU 1 272 000

Tax on projected remuneration:

CU 1 272 000 – CU 708 310 = CU 563 690 \* 41% = CU 231 113 + CU 209 032  
= CU 440 145

Tax on awards = CU 440 145 – CU 410 625 (a) = CU 29 520

**2019:** Nil

(c) SDL at 1% (payable by the employer):

**2016:** CU 1 000 000 \* 1% = CU 10 000

**2017:** CU 1 100 000 \* 1% = CU 11 000

**2018:** CU 1 200 000 \* 1% = CU 12 000

**2019:** CU 1 200 000 \* 1% = CU 12 000

(d) UIF at 2% (incorporating 1% each for the employer and the employee):

**2016:** CU 1 000 000 \* 2% = CU 20 000

**2017:** CU 1 100 000 \* 2% = CU 22 000

**2018:** CU 1 200 000 \* 2% = CU 24 000

**2019:** CU 1 200 000 \* 2% = CU 24 000

The table above illustrates that Director A is liable for income tax each year on the full amount of remuneration received, including salary, bonus and equity awards. The company computes the tax using applicable rates for individuals and pays over the amount directly to SARS. Director A also pays the required SDL and UIF each month, which are withheld by the company and paid directly to SARS. Each year, the company qualifies for s 11(a)<sup>462</sup> general deduction for the salaries paid to Director A. The cash bonus in 2016 also constitutes expenditure incurred in the course of trade and qualifies for this deduction. For the equity awards and in line with the reasoning discussed in scenario 1 above, the researcher proposes that the company be allowed this deduction as the award was granted for revenue purposes.

In 2019, it was found that the net income thresholds had not been met; hence, a decision was made to clawback the equity awards previously paid out. The clawback occurs in a tax year

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<sup>462</sup> ITA, 1962: s 11(a)

subsequent to payment. King IV allows the board of directors to exercise discretion in determining the manner of clawback. In this case, Director A earned equity awards in excess of what should have been earned had net income been calculated correctly. This resulted in an overpayment of income tax in each year.

Section 99(1) of TAA grants that taxpayer a 3-year period to rectify a submitted tax return provided there has been no intentional misrepresentation, fraud or misconduct. In this scenario, the error resulted from oversight, and in accordance with s 102, the onus rests upon Director A to prove this. Lengthy legal processes may ensue, as the desired outcome is a refund from SARS. In addition, SARS may investigate tax returns relating to prior years for accuracy. As there is currently no defined approach on how to account for the taxation consequences on the clawback locally, the approach adopted by the USA can be considered here. Properly documented policy and agreements in writing should also be kept by the company to adequately facilitate the clawback process.

### **6.1.3 Scenario Three**

#### Clawback from former employees

This scenario replicates scenario 2 except for the following:

Director A's contractual term at the company ends on 30 November 2019. As such, he resigns on this date and receives a salary of CU 1 100 000 for the year. In accordance with Director A's employment conditions, he is entitled to a severance pay lump sum in cash amounting to CU 450 000 upon resignation, the payment of which is deferred to 1 February 2020.

#### **6.1.3(a) - USA Tax Implications**

The tax implications up to 31 December 2018 are identical to that described in scenario 2 above. A discussion on the 2019 tax implications ensues below.

Director A includes the salary of CU 1 100 000 in gross income and is liable for the necessary FICA taxes, similar to scenario 2 above. On the same date, Director A completes his contractual term at the company and resigns. On 31 December 2019, the oversight error was detected and an accounting restatement was required. The clawback of CU 135 000 representing the excessive amount paid to Director A in prior years was then enforced.

According to s 409A,<sup>463</sup> deferred compensation is included in gross income once a non-forfeitable right to the payment is established. Director A fulfils the terms of his employment contract and qualifies for the lump sum severance payment on 30 November 2019. Upon signature of the employment contract, a legally binding right to the payment is established. Once the conditions have been satisfied, the right to the payment vests in Director A.<sup>464</sup> It is only on this date (30 November 2019) that a non-forfeitable right to the payment is established. The payment is however only due to be made on 1 February 2020. According to Roberts & Holland,<sup>465</sup> where a payment of deferred compensation is 'actually or constructively' made with 2.5-months of the company's year-end, this payment qualifies for the short-term deferral exemption under s 409A.

Payments qualifying for this exemption do not have to comply with the rigorous requirements of s 409 A regarding timing of the deferrals. Instead, the amounts whether paid out in instalments or in a lump sum are included in gross income of the recipient on the vesting date.<sup>466</sup> As such, Director A includes the severance pay lump sum in gross income on 30 November 2019, being the date of accrual.

According to Revenue ruling 79-311,<sup>467</sup> amounts paid to Director A are disclosed to the IRS on a gross basis. Director A would then apply the claim of right doctrine to recover taxes overpaid in prior years on the amount clawed back. Note that the amount of the clawback, CU 135 000 and the related income tax amounting to CU 51 588 as well as the discussion on the application of the claim of right doctrine is the same as for scenario 2. According to Erwin,<sup>468</sup> severance

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<sup>463</sup> IRC, 1986: s 409A

<sup>464</sup> Sholk, 2008

<sup>465</sup> Roberts & Holland LLP, 2008: 1

<sup>466</sup> Bainbridge, 2016

<sup>467</sup> Barker & O'Brien, 2010: 440

<sup>468</sup> Erwin, 2014

payments resulting from an involuntary resignation constitute taxable wages that are subject to FICA.

The tax implications for 2019 are as follows:

TABLE 10<sup>469</sup>

Description	2019	
	Option 1 (Includes Clawback)	Option 2 (Excludes Clawback)
Annual Salary	CU 1 100 000	CU 1 100 000
Severance Pay	CU 450 000	CU 450 000
Clawback	(CU 135 000)	Nil
<b>Net Taxable Income</b>	<b>CU 1 415 000</b>	<b>CU 1 550 000</b>
Income Tax for 2019 <sup>470</sup>	(CU 488 538) (a)	(CU 538 488) (a)
Tax Saving from 2016 – 2018	Nil	CU 51 588
<b>FICA Taxes<sup>471</sup> (7.65%)</b>	<b>(CU 118 575) (b)</b>	<b>(CU 118 575) (b)</b>
- Medicare (1.45%)	(CU 22 475) (c)	(CU 22 475) (c)
- Social Taxes (6.2%)	(CU 96 100) (d)	(CU 96 100) (d)
<b>Net Income for 2019</b>	<b>CU 807 887</b>	<b>CU 944 525</b>

An extract from the tax tables applicable to each year are included below:

2019 <sup>472</sup>	\$ 510 301 or more	\$ 153 798.50 plus 37% of the amount above \$ 510 300
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<sup>469</sup> Author's own compilation

<sup>470</sup> Orem, 2019

<sup>471</sup> ADP, 2018: 1

<sup>472</sup> Orem, 2019

Calculations:

$$(a) \text{ Option 1: } \text{CU } 1\,415\,000 - \text{CU } 510\,300 = \text{CU } 904\,700 * 37\% = \text{CU } 334\,739 + \text{CU } 153\,798.5 \\ = \text{CU } 488\,538$$

$$\text{Option 2: } \text{CU } 1\,550\,000 - \text{CU } 510\,300 = \text{CU } 1\,039\,700 * 37\% = \text{CU } 384\,689 \\ + \text{CU } 153\,798.5 = \text{CU } 538\,488$$

$$(b) \text{ CU } 1\,100\,000 + \text{CU } 450\,000 = \text{CU } 1\,550\,000 * 7.65\% = \text{CU } 118\,575$$

$$(c) \text{ CU } 1\,100\,000 + \text{CU } 450\,000 = \text{CU } 1\,550\,000 * 1.45\% = \text{CU } 22\,475$$

$$(d) \text{ CU } 1\,100\,000 + \text{CU } 450\,000 = \text{CU } 1\,550\,000 * 6.2\% = \text{CU } 96\,100$$

As shown above, option 2 is more favorable Director A. Director A also benefits from the reduction in tax rates between 2016 and 2019 on the portion clawed back. Director A also pays FICA taxes on the full amount of remuneration received in 2019, including the severance pay lump sum and excluding the amount clawed back. The overpayment in FICA taxes in prior years will be recovered by the company directly from the IRS and refunded to Director A.

This example illustrates that the process of effecting a clawback from a former employee is the same as for an existing employee. The tax rules and benefits available to Director A and the company are the same. If however the severance pay lump sum was paid out after the 2.5-month exemption window, the rules of s 409A would apply and may influence the tax treatment.

### **6.1.3(b) - SA Tax Implications**

The tax implications for Director A would be the same as in scenario 2 up to 31 December 2018. On 31 December 2019, a decision is taken to clawback the awards granted in prior years amounting to CU 135 000. Scenario 2 details the current position in South Africa with respect to the tax implications on this clawback. The same reasoning applies in this scenario.

On 30 November 2019, Director A completes his contractual term and qualifies for the severance pay lump sum amounting to CU 450 000. This severance pay lump sum constitutes remuneration for Director A as it is earned from services rendered to the company. In terms of the definition of

gross income, taxation is levied on the earlier of receipt or accrual.<sup>473</sup> According to Stiglingh et al.,<sup>474</sup> the date of accrual refers to the date on which ‘the taxpayer became entitled to the amount ... the time that a taxpayer obtains a vested right to a future payment, the amount accrues to a taxpayer.’

Although the payment of the lump sum is due to occur on 1 February 2020, Director A has met the necessary requirements on 30 November 2019. As such, the severance pay amounting to CU 450 000 accrues to Director A on this date and is therefore included in gross income.

The taxation implications for 2019 are as follows:

**TABLE 11**<sup>475</sup>

<b>Description</b>	<b>2019</b>
Annual Salary	CU 1 100 000
Severance Pay	CU 450 000
<b>Total Remuneration</b>	<b>CU 1 550 000</b>
- <b>Income Tax/ PAYE</b>	<b>(CU 552 541)</b>
- Annualised Regular Income (a)	(CU 368 041)
- Annualised Irregular Income (b)	(CU 184 500)
<b>Other Employment Taxes</b>	<b>(CU 46 500)</b>
- SDL at 1% (c)	(CU 15 500)
- UIF at 2% (d)	(CU 31 000)
<b>Net Amount</b>	<b>CU 950 959</b>

The following rates are applicable to the 2019 year of assessment:<sup>476</sup>

<b>Year</b>	<b>Taxable Income</b>	<b>Tax Rates</b>
2019	708 311 – 1 500 000	207 448 + 41% of taxable income above 708 310

<sup>473</sup> ITA, 1962: s 1

<sup>474</sup> Stiglingh et al., 2018: 37

<sup>475</sup> Author's own compilation

<sup>476</sup> SARS, 2019b

### Calculations

(a) Tax on Annualised Regular Income:

$$\begin{aligned} \text{CU } 1\,100\,000 - \text{CU } 708\,310 &= \text{CU } 391\,690 * 41\% = \text{CU } 160\,593 + \text{CU } 207\,448 \\ &= \text{CU } 368\,041 \end{aligned}$$

(b) Tax on Annualised Irregular Income:

$$\text{Projected Total Remuneration: CU } 450\,000 + \text{CU } 1\,100\,000 = \text{CU } 1\,550\,000$$

Tax on projected remuneration:

$$\begin{aligned} \text{CU } 1\,550\,000 - \text{CU } 708\,310 &= \text{CU } 841\,690 * 41\% = \text{CU } 345\,093 + \text{CU } 207\,448 \\ &= \text{CU } 552\,541 \end{aligned}$$

$$\text{Tax on awards} = \text{CU } 552\,541 - \text{CU } 368\,041 \text{ (a)} = \text{CU } 184\,500$$

(c) SDL at 1% (payable by the employer):

$$\mathbf{2016: CU } 1\,550\,000 * 1\% = \text{CU } 15\,500$$

(d) UIF at 2% (incorporating 1% each for the employer and the employee):

$$\mathbf{2016: CU } 1\,550\,000 * 2\% = \text{CU } 31\,000$$

The table above illustrates that Director A is liable for income tax each year on the full amount of remuneration received, including the annual salary and severance pay. The company computes the tax using applicable rates for individuals and pays over the amount directly to SARS. SDL and UIF are also computed by the company and paid over to SARS each month. The company also qualifies for s 11(a)<sup>477</sup> general deduction for the remuneration paid to Director A.

In contrast to the USA, local legislation does not provide a 2.5-month window period for deferred amounts in determining the timing of the accrual. The date of accrual is solely determined by the date on which the taxpayer becomes unconditionally entitled to receive the amount. With respect to clawing back amounts from severance pay, or other termination benefits, local legislation has not been adequately developed in this area. Once an employee has terminated his services to an employer, companies cannot recover amounts previously overpaid, unless through legal means

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<sup>477</sup> ITA, 1962: s 11(a)

which is very costly. A suggestion is that South Africa considers the approach applied the USA, as local remuneration policy does tend to mimic that of the USA.<sup>478</sup>

## 6.2 PART B: CLASSIFICATION OF INCENTIVE AWARDS AS REMUNERATION

In the USA, the concept of 'pay for performance' is applied in determining what constitutes remuneration.<sup>479</sup> This concept aligns company expectations to individual performance. Incentive awards, in the form of cash or equity are therefore included as part of remuneration. The underlying principle applied in the USA is to adequately reward employees for the services rendered. Consequently, improved performance is encouraged.

In South Africa on the other hand, the 'ability to pay' tax principle is applied.<sup>480</sup> This principle states that the amount of taxation levied should be based on the individual's wealth and capacity to pay.<sup>481</sup> The main reason for cash and equity incentives being included as part of remuneration is to bridge the gap between higher and lower income earners. Higher income earners have more flexibility when it comes to structuring their remuneration packages, when compared to lower income earners. As such, higher income earners may obtain tax advantages that lower income earners may not qualify for. To mitigate this problem, cash and equity incentives are included as part of remuneration.

Although cash and equity incentive awards are meant to encourage better performance, in South Africa the tax implications do not concur with this objective. South Africa taxes revenue at higher effective rates when compared to capital. This discourages risk-taking and investment. The inclusion of these awards in remuneration is however more advantageous to the fiscus from a tax collection point of view.

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<sup>478</sup> Madlela, 2018: 46

<sup>479</sup> Kambil, 2010: 2-3

<sup>480</sup> Kenton, 2018b

<sup>481</sup> Kenton, 2018b

According to Meer,<sup>482</sup> Adam Smith highlighted four canons, which form the basis of a well-functioning taxation system. These include equality, certainty, economy and convenience. The principle of equality states that individuals with greater financial means should pay higher taxes, whilst poorer individuals should pay lower amounts of tax. This principle is in line with the 'ability to pay' principle currently applied in South Africa, which strives to facilitate a better balance in terms of wealth distribution in the country.

The canon of certainty requires transparency in the tax enforceability and collection process. The taxpayer should understand the reasons and purpose, for which taxes are levied. The canon of convenience builds onto this in that the payment process should be simple, expedient and user-friendly. The canon of economy suggests that effective tax collection is pivotal in supporting economic growth. Costs associated with tax collection should be appropriately managed so that amounts collected from taxpayers is reinvested into developing communities.<sup>483</sup>

As South Africa is a developing country with large gaps between the wealthy and the poor, the application of the four canons is more appropriate in terms of stimulating economic growth. The concept of 'pay for performance' applied in the USA is also good in terms of encouraging morale in the workplace, but it should be noted that the USA is a developed economy and is not directly faced with social and economic upliftment issues. In South Africa, imposing higher taxes on the wealthy does appear to be unfair, but it is needed to sustain the economy.

South Africa's constitution is also founded on the Bill of Rights. Section 9<sup>484</sup> of this bill demands equality for all citizens and therefore legislation enacted needs to ensure that no population group is unfairly discriminated against. In light of this, the current taxation regime in South Africa with respect to remuneration strives to minimize the benefits that higher income earners may be entitled to which lower income earners are denied.

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<sup>482</sup> Meer, 2013

<sup>483</sup> Meer, 2013

<sup>484</sup> Constitution, 1996: 5-6

### 6.3 PART C: THE IMPACT OF CLAWBACK ON VESTING

In the USA, both SOX and s 10D specify that clawback may only be implemented if an accounting restatement occurs resulting from non-compliance with financial reporting measures. The trigger event for the clawback is non-satisfaction of financial metrics. Non-compliance with non-financial metrics do not result in a clawback. Additionally, the enforceability of the clawback has no impact on the vesting date of the award. Awards are deemed to vest once financial metrics have been satisfied.

In contrast to this, South African tax law needs to be developed with respect to clawback. Currently the ITA only distinguishes between restricted and unrestricted equity instruments. Restricted equity instruments are subject to various conditions and only vest once the conditions have been satisfied. The inclusion of a clause to clawback the award at a future date amounts to a further restriction, which then impacts on the vesting date of the award. The gross income inclusion of s 8C gains only occur on the vesting date, whilst the enforceability of a clawback is a contingent event. Furthermore, s 34 of the BCEA only allows employers to recoup amounts overpaid to employees if resulting from a mathematical calculation error, or in the case of damages or losses caused by the employee. No guidance is given on how to clawback amounts from former employees.

With respect to the clawback, it would be advantageous to revisit existing legislation and the definition of a restricted equity instrument in the ITA. The enforceability of a clawback should not affect the vesting date of the awards. Awards should vest once all other criteria for vesting have been satisfied. Similar to the approach adopted in the USA, specific criteria should be established which serve as a trigger event for the clawback. Once these criteria have been met, employers should be entitled to clawback amounts. In light of the numerous scandals occurring currently in South Africa, it is suggested that misconduct form the basis of the clawback. Misconduct includes misappropriation, intentional misrepresentation, fraud, and money laundering to name a few. Once such an act is identified, employers should be able to recover amounts from existing or former employees. The Companies Act and BCEA should also be more specific regarding employer rights over employees pertaining to unsatisfactory performance and misconduct.

## **7. CHAPTER FIVE - CONCLUSION**

### **7.1 SUMMARY OF KEY FINDINGS AND CONCLUSION**

South African legislation governs the treatment of cash and share incentive awards up to the point of vesting. Subsequent to vesting, King IV allows the board of directors to apply discretion in enforcing a clawback. In light of state capture and the numerous corporate scandals currently in occurrence, there is an urgent need for legislative mechanisms to be instituted that address executive accountability and responsibility in decision-making. In addition to the development of tax law, existing legislation also needs to be revisited in an effort to strike a balance between employee right to payment and responsibilities towards the employer. This study provided clarity on the manner in which clawbacks are applied in the USA in an effort to provide a framework that could be adopted in South Africa. These rules have been developed and implemented over the past decade, and have proven to be effective in practice.

This study found that South Africa needs to legislate the manner in which clawback should be effected rather than leave it to the discretion of the board of directors or remuneration committee. A clear set of rules would ensure consistency in application between companies along with facilitating the efficient recovery of funds from executives. Likewise, an effective internal control environment is crucial in reducing the risk of undetected error.

Two mechanisms are currently adopted by the USA with respect to clawing back amounts previously paid out to executives. The first being a clawback in the form of repayment of funds, and the second being a clawback in the form of withholding future remuneration. Both methods are effective in the USA, as the legislative environment has been developed over the years to accommodate this. Moreover, the taxation consequences of the amounts clawed back have been refined to such an extent that even former employees are refunded for excess taxes paid in prior years. The underlying substance of the clawback transaction is considered so that the tax consequences thereon do not jeopardize either the taxpayer or the company.

In light of this and the need for legislative transformation, it is submitted that South Africa consider the option to recover funds in a manner similar to that applied in the USA. Clawback should be effected locally through repayments and through the withholding of future remuneration. Corruption is rife in South Africa, and responsible leadership is lacking. Clawback can therefore be used as a mechanism in mitigating the adverse economic effects that result from self-interest and corporate mismanagement.

Considering the current economic environment, the researcher is of the view that it may be easier to effect a clawback from future remuneration of existing employees, rather than to request repayment. Existing legislation would however need to be expanded to allow for this. Clawback in the form of repayment can then be built onto this at a later stage. Currently, the regulatory regimes do not provide companies with much recourse to recover amounts paid to former executives. Whilst the legal route is available, this option is very costly.

Furthermore, clawback should be included in company policy, and agreed to in writing by all parties. Informal agreements do not facilitate adequate implementation and may lead to increased legal costs which otherwise may be avoided. Legislation in the USA currently allows for clawback of the full amount of an incentive award under SOX, or alternatively clawback of the excessive portion of an incentive award under s 10D. Although there is merit in effecting both clawbacks, the requirements to enforce the SOX clawback are more cumbersome. A more simplistic, direct approach is provided by s 10D. It is therefore submitted that the framework of s 10D be explored for implementation locally. Clawing back excessive amounts previously overpaid serves as a remedial measure in terms of rectifying past errors, when compared to clawing back the full amount as proposed by SOX, which is more punitive. The researcher is of the view that once employers recover excessive amounts successfully, then legislation may be expanded to recover the full amount paid out in error. Whilst remedial measures are necessary, punitive measures are also required considering the extent of foul play in the corporate sector.

The concept of linking the enforceability of the clawback to non-compliance with a specific action also provides a great deal of clarity. It is therefore submitted that South Africa define certain benchmarks that should trigger the enforceability of the clawback. As suggested in the previous

chapter, misconduct is endemic in this country; hence, it forms a good basis on which to clawback amounts previously paid out.

The claim of right doctrine applied in the USA strives to compute the effect that information arising subsequent to the initial payment of an award would have had on the taxpayer had the information been known from the onset. In the researcher's opinion, this approach is fair in that it seeks to compensate the taxpayer for taxes previously paid on amounts that have now been refunded to the employer. The tax benefit rule also requires the employer to pay taxes on amounts that are recovered, which were previously deducted from gross income. It is submitted therefore that this approach allows for the substance of the transaction to be accurately recorded in the year in which it occurs. Once this approach for existing employees is adopted, it is suggested that the same approach be expanded upon to include clawback from former employees as this system represents a practical application of the principles of transparency, equality and fairness, which concurs with the South African constitution.

The study also found that cash and equity incentive awards are included as part of remuneration in both the USA and South Africa. The rationale for inclusion is however different. The USA, being a developed economy strives to incentivize good performance by granting these awards, while South Africa's key objective is to bridge the earning gap between the wealthy and the poor. Considering the stage of growth in each economy at present, the researcher is of the view that the approach adopted by the USA and South Africa is appropriate, except that South Africa faces an additional challenge when it comes to balancing taxes and retaining executive talent. The tax implications on incentive awards should therefore not serve as a deterrent to executives but should rather act as a catalyst to good performance.

The taxation regime in South Africa also needs to be competitive on the global stage. In order to facilitate this and in line with Adam Smith's four canons, effective tax collection is pivotal. The development of the tax law around clawback would assist in achieving this objective. Similarly, effective law enforcement is also crucial in ensuring that compliant taxpayers are not penalized for fiscal deficits whilst the transgressors remain free. Organs of state therefore need to work together to eradicate corruption and introduce policies and controls that facilitate economic

progression. For the purposes of this research report, an amendment to the tax legislation governing clawback is therefore proposed in the manner illustrated above.



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