

Employee share schemes: Tax deductibility of employer contributions



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Many employee share incentive schemes work as follows: The employer company forms a scheme trust. The company pays a non-refundable cash contribution (or grant) to the trust (instead of, say, lending cash to the trust). The trust uses the cash to buy, or subscribe for, shares in the employer company or another related company. Eligible employees are given the opportunity to participate in the scheme by, say, acquiring units in the trust, subject to the employees continuing to comply with certain conditions over a number of years.

As long ago as 2009, the South African Revenue Service (SARS) ruled that an employer who makes cash grants to a share scheme trust may deduct the amount of the grants in terms of the general deduction provision in s11(a) of the Income Tax Act, No 58 of 1962 (Act) (see SARS Binding Private Ruling 050 dated 16 October 2009 (BPR 050)). One should note that BPR050 only applied to its specific facts.

The deductibility of employer contributions or grants was the subject of a recent case in the Cape Town Tax Court, *S G Taxpayer v Commissioner for the South African Revenue Service*, Case No IT 14264.

The facts in the case were the following: The taxpayer, an operating company, (OpCo) established an employee share

incentive scheme (Scheme) for its employees. Under the Scheme, a company (HoldCo), the holding company of OpCo, formed a trust (Trust). The Trust was a discretionary trust. HoldCo was the sole beneficiary of the Trust.

A new company was formed by the Trust (NewCo). The employees of OpCo were offered and acquired shares in NewCo. The NewCo shares were subject to certain lock-in provisions in respect of the employees.

OpCo and the Trust concluded a contribution agreement. Under the agreement, OpCo agreed to contribute a non-refundable amount (Contribution) to the Trust. The Trust had to use the Contribution to incentivise eligible employees in accordance with the Scheme rules and, for that purpose, used the Contribution to subscribe for redeemable preference shares (NewCo Prefs) in NewCo.

NewCo, in turn, used the subscription price of the NewCo Prefs to buy shares in HoldCo.

Over time, the value of the shares in HoldCo increased significantly. NewCo decided to redeem the NewCo Prefs by transferring HoldCo shares to the Trust. NewCo sold shares in HoldCo and paid dividends to the Scheme participants.

OpCo claimed the Contribution as a deduction against its taxable income in terms of s11(a) of the Act. Initially, SARS allowed the deduction. Subsequently, however, it issued an additional assessment disallowing the deduction. SARSs reason for disallowing the deduction was that HoldCo was the sole beneficiary of the Contribution as it (as beneficiary of the Trust) would benefit from the investment in the NewCo Prefs (through redemption and dividends); and the Scheme participants did not benefit from the Contribution. SARS argued that the Contribution paid by OpCo was accordingly not incurred in the production of its income, as required under s11(a) of the Act as there was no direct causal link between the payment of the Contribution and the production of income

from the Contribution.

The Tax Court referred to certain well-established principles, namely, that the test is not whether there is a causal link but whether there is a sufficiently close connection between the expense and the income; that it is not necessary for the taxpayer to show that a particular item of expenditure produced any part of the income; and that, provided the taxpayer can show that the purpose of the expense was to produce income, any incidental benefit to a third party does not preclude the taxpayer from deducting the expense.

The Tax Court heard evidence from the auditor who advised on the Scheme, and from a participant in the Scheme.

The Court held as follows (at paragraphs 46 and 49):

On the evidence, the dominant purpose in the establishment and implementation of the scheme was to protect and enhance the business of the taxpayer [OpCo] and its income, by motivating its key staff to be efficient and productive and remain in the taxpayers employ. ...

The mere fact that the taxpayer foresaw that HoldCo would potentially also benefit from the redemption of the NewCo preference shares cannot negate the taxpayers purpose and intention, which was actually effected by the scheme insofar as the value of the NewCo shares increased significantly, and this benefit, together with the dividends declared by NewCo on the remaining HoldCo shares following the preference share redemption, actually accrued to the scheme participants. The increase in the value of the HoldCo shares is directly attributable to the increase in the turnover and profits of the taxpayer, being the main operating subsidiary of HoldCo.

The Court accordingly held that there was a sufficiently close link between OpCos expenditure of the Contribution and its income-producing operation.

The judgment is good news for taxpayers. However, the following should be noted:

- The Court quoted extensively from the Contribution agreement. It was apparent that the agreement was carefully drafted and set out the rationale for the Scheme and the Contribution in detail. In other words, when setting up an incentive scheme, it is critical that employers document the purpose and operation of the scheme meticulously.
- In the Tax Court case, the advisors on, and the participants in, the Scheme clearly had a good understanding and recollection of the way the Scheme worked and the purpose of the Scheme. Accordingly, it is important that taxpayers, when setting up a share incentive scheme for employees, obtain and retain comprehensive written advice from professionals in relation to the manner in which the scheme should operate and what the incidence of tax will be for all parties in the scheme.
- A contribution or grant in such cases must be spread over the period of the anticipated benefit to be derived by participants in terms of 23H of the Act (as pointed out by SARS in BPR 050 and as was done by OpCo in the Tax Court case).