Exemption employee share ownership plan rulings

Introduction

The tax implications for the various participants of a share incentive scheme are complex and the legislation is not necessarily clear. In recent years, share incentive schemes have been a particular focus of the South African Revenue Service (SARS) and the National Treasury, and there have been regular amendments to the tax legislation. It is no wonder that SARS is issuing a number of binding private and binding class rulings that relate to share incentive schemes.

Rulings

Binding Private Ruling 161 is one such recent ruling. Released on February 5 2014, the ruling deals with the income tax and employees’ tax consequences for the employer and the trust used to facilitate an employee share ownership plan (ESOP).

The purpose of the ESOP is to allow qualifying employees to participate in the benefits attributable to the shares of a Johannesburg Stock Exchange-listed holding company (HoldCo). This update does not discuss the mechanics of the ownership plan in detail, but the following should be noted:

- The trust allocated notional units to the participants of the ESOP to determine their participation in the dividends and net capital proceeds attributable to the HoldCo shares.
- The employer made an annual contribution to the trust, which would be used by the trust to acquire shares in the HoldCo.
- As soon as the trust had acquired the HoldCo shares, the trust would confirm with the founder of the trust that units were available for allocation to qualifying employees.
employees. If the qualifying employees accepted the units, they would become participants of the ESOP.

- Importantly, the rights attached to the units entitled the participants to:
  - an immediate vested right to dividends received by the trust;
  - an immediate vested right to the net capital proceeds realised by the trust on disposal of the shares; and
  - a vested right to the shares held by the trust when the trustees exercised their discretion to vest the shares in the participants.

- The participants were ‘locked-in’ for a specific period and were not entitled to dispose of any of the units or shares during the lock-in period. Participation in the ESOP was subject to a number of other restrictions.

One of the more contentious issues that Ruling 161 considered was whether the contributions by the employer to the trust for purposes of the ESOP were deductible for purposes of Section 11(a), read with Section 23(g) of the Income Tax Act, (58/1962). For instance, were such contributions by the employer to the trust “in the production of its income” and “not of a capital nature”? These questions were especially relevant given that the contributions received by the trust would not necessarily be included in its gross income (which was confirmed in Ruling 161).

There is case law (Provider v Commissioner of Taxes, 17 SATC 40) to support the argument that – provided that the contributions to the trust are made by an employer in respect of its own employees and the undertaking to do so is given upfront – the employer should be entitled to a deduction for its contributions to the trust. Ruling 161 confirmed that the employer’s contributions to the trust for purposes of this particular ESOP would be deductible under Section 11(a), read with Section 23(g) of the act. A similar ruling was issued in
Binding Private Ruling 50.

However, in Ruling 161, no opinion was expressed on the application of Section 23H of the act. Whereas in Ruling 50, SARS indicated Section 23H would apply, but did not indicate how it would apply. The purpose of Section 23H is to match the date on which the expenditure may be claimed by a taxpayer to the date on which the benefit is enjoyed by the taxpayer (ie, where the benefit is not enjoyed by the taxpayer in the same year of assessment). Unfortunately, it was not clear over which period the deduction was to be apportioned in Ruling 161, or whether the employer would be entitled to a deduction each year that a contribution was made to the trust.

Where an ESOP is implemented using a special purpose vehicle, the issue often arises that the special purpose vehicle has no cash from which to withhold the employees’ tax obligations, triggered as a result of the vesting of a restricted equity instrument in a participant in terms of Section 8C of the act (ie, on the lifting of the ‘lock-in period’). Ruling 161 indicated that:

- if the trust has no funds, the employer will be liable to withhold employees’ tax on each Section 8C gain made by a participant; and
- if the trust has funds, the trust will be required to register as an employer and withhold an amount of employees’ tax.

Ruling 161 also indicated that employer’s contributions to the trust will not be subject to donations tax under Section 54, and that the contributions received by the trust will be of a capital nature and thus not included in the trust’s gross income in Section 1.

Comment

Binding private and binding class rulings are binding only between SARS and the applicant(s) to the ruling. Other persons
may not cite binding private and binding class rulings in any proceedings, including court proceedings, against SARS. Taxpayers requiring certainty on the tax implications of share incentive schemes, which are complex and sometimes uncertain, should therefore apply to SARS for their own advanced tax rulings.

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Employee share ownership plan ruling

Author: Andrew Lewis (Senior Associate at Cliff Dekker Hofmeyr)

The tax implications for the various participants of a share incentive scheme are complex and the legislation is not necessarily clear. In recent years, share incentive schemes have been a particular focus of the South African Revenue Service (SARS) and National Treasury with regular amendments to the tax legislation. It is no wonder that we see a number of binding private and binding class rulings being issued by SARS that relate to share incentive schemes.

Binding Private Ruling No 161 (BPR 161) is one such recent ruling, released on 5 February 2014, which deals with the income tax and employees’ tax consequences for the employer company and the trust used to facilitate an employee share ownership plan (ESOP).
The purpose of the ESOP is to allow qualifying employees to participate in the benefits attributable to the shares of the employer company’s JSE listed holding company (HoldCo). We do not discuss the mechanics of the ESOP in detail but note that:

- A trust allocated notional units to the participants of the ESOP to determine their participation in the dividends and net capital proceeds attributable to the HoldCo shares.
- The employer company made an annual contribution to the trust, which would be used by the trust to acquire shares in HoldCo.
- As soon as the HoldCo shares had been acquired by the trust, the trust would confirm with the founder of the trust that units are for allocation to qualifying employees. If the qualifying employees accepted the units they would become participants of the ESOP.
- Importantly, the rights attached to the units entitled the participants to:
  - An immediate vested right to dividends received by the trust;
  - An immediate vested right to the net capital proceeds realised by the trust upon disposal of the shares; and
  - A vested right to the shares held by the trust when the trustees exercise their discretion to vest the shares in the participants.

- The participants are ‘locked-in’ for a specific period and are not entitled to dispose of any of the units and/or shares during the lock-in period. A participants’ participation in the ESOP is subject to a number of other restrictions.

One of the more contentious issues which BPR 161 considered is
whether the contributions by then employer company to the trust for purposes of the ESOP are deductible for purposes of s11(a), read with s23(g) of the Income Tax Act, No 58 of 1962 (Act). For instance, are such contributions by the employer company to the trust ‘in the production of its income’ and ‘not of a capital nature’? These questions are especially relevant if one considers that the contributions received by the trust will not necessarily be included in its gross income (which was confirmed in BPR 161).

There is case law (Provider v Commissioner of Taxes, 17 SATC 40) to support the argument that provided the contributions to the trust are made by an employer company in respect of its own employees and the undertaking to do so is given upfront, the employer company should be entitled to a deduction for its contributions to the trust. BPR 161 confirmed that the contributions by the employer company to the trust for purposes of this particular ESOP will be deductible under s11(a), read with s23(g) of the Act. A similar ruling was issued in Binding Private Ruling No 50 (BPR 50).

However, in BPR 161, no opinion was expressed on the application of s23H of the Act. Whereas, in BPR 50, SARS indicated that the provisions of s23H would be applicable but did not indicate how one should apply the attendant provisions. The purpose of s23H of the Act is to match the date upon which the expenditure may be claimed by a taxpayer to the date upon which the benefit is enjoyed by the taxpayer (ie where the benefit is not enjoyed by the taxpayer in the same year of assessment). Unfortunately, it is not clear over which period the deduction is to be apportioned in BPR 161 or whether the employer company may be entitled to a deduction each year that a contribution is made to the trust.

Where an ESOP is implemented using a special purpose vehicle (SPV), the issue often arises that the SPV does not have the cash from which to withhold the employees tax obligations triggered as a result of the vesting of a restricted equity
instrument in a participant in terms of s8C of the Act (ie upon the lifting of the ‘lock-in period’). BPR 161 indicated that:

- If the trust does not have any funds, the employer company will be liable to withhold the employees tax on each section s8C gain made by a participant; and
- If the trust does have funds, the trust will be required to register as an employer and withhold an amount of employees’ tax.

It is worth mentioning that BPR 161 also indicated that the contributions by the employer company to the trust will not be subject to donations tax under s54 of the Act and that the contributions received by the trust will be of a capital nature and thus not included in the trust’s gross income in s1 of the Act.

It should always be appreciated that binding private and binding class rulings are only binding between SARS and the applicant(s) to the ruling. Other persons may not cite binding private and binding class rulings in any proceedings, including court proceedings, against SARS. Taxpayers requiring certainty on the tax implications of share incentive schemes, which are complex and sometimes uncertain, should therefore apply to SARS for their own advanced tax rulings.

Treasury Plans to Tax Dividends Paid to Employees
as Income

Changes proposed by the Treasury in the Taxation Laws Amendment Bill follow international trends in tightening the net on the use of salaries disguised as dividends.

According to the explanatory memorandum published by the Treasury recently, many share schemes hold pure equity shares where the sole intent of the scheme is to generate dividends for employees as compensation for past or future services rendered, without the employees ever obtaining ownership of the shares.

The Treasury says it has become apparent that the anti-avoidance rules in the conversion of salary to dividends in the South African context have been “too narrow”, as they have only targeted dividends for non-equity shares.

The Treasury’s legal tax design director Beatrie Gouws said this week that policy dictates that if an employer pays an employee for services rendered, the amount should be included in gross income and taxed at marginal rates, irrespective of how the employer has funded the payment.

“An anti-avoidance rule was required to ensure that salary disguised as a dividend would be taxable at marginal rates in the hands of the employee,” she said.

Werksmans Attorneys tax director Ernest Mazansky said the purpose of the changes, coming into effect in March next year, was to deal with situations where a trust is established for employees, with the trust holding shares in the employer company and the dividends being distributed to the employees.

“The government considers this to be just another form of remuneration, and therefore the dividends should be fully taxable as income, so instead of paying 15% on the dividend income it will be taxed as income at the taxpayer’s rate.”
Mr Mazansky said the wording of the new rule has wider consequences. If an employee has obtained the shares years ago, placed it in a family trust and retired since, then the anti-avoidance rule will apply to the dividends derived from the shares in the family trust and it will be taxed as income and not dividends.

Ms Gouws said that the provision does not apply to dividends paid in respect of a restricted equity share scheme or in respect of a share held by the employee.

The new anti-avoidance measure will not apply if the share fully vests in the hands of the employee, or the employee has paid in full and taken ownership of the share and then transfers it to a different entity. Ms Gouws added that it would also not apply if an employee purchases shares in his employer on the open market, pays in full for the shares and subsequently receives dividends in respect of the shares.

According to the Treasury's explanatory memorandum the changes will be applicable in respect of dividends accrued on or after March 1 next year.

Changes To The Taxation Of Dividends In Employee Share Schemes

Author: Stephan Spamer & Mareli Treurnicht (ENS)

As a general rule, subject to certain exceptions, local dividends received and accrued to a South African tax resident are exempt from normal tax in terms of section 10(1)(k) of the
Income Tax Act, 1962 ("ITA"). One such exception applies to employee share schemes by virtue of the application of section 10(1)(k)(i)(dd).

**Section 10(1)(k)(i)(dd) of the ITA**

Section 10(1)(k)(i)(dd), which was introduced from 1 January 2011, prescribes that a dividend will not be exempt from normal tax if such dividend is received or accrued in respect of a restricted equity instrument (as defined in section 8C) unless:

- the restricted equity instrument constitutes an ‘equity share’ for purposes of the ITA, other than an equity share that would have constituted a ‘hybrid equity instrument’ as defined in section 8E but for the 3-year period requirement; or
- the dividend constitutes an equity instrument; or
- the restricted equity instrument constitutes an interest in a trust and, where that trust holds shares, all of those shares constitute equity shares, other than equity shares that would have constituted hybrid equity instruments as defined in section 8E but for the 3-year period requirement.

Accordingly, dividends in respect of restricted equity instruments (for purposes of section 8C) will be taxed as normal income in the hands of the recipient, unless it falls within one of the abovementioned exclusions. The tests to be applied in each instance are as follows:

**First Test: the employee must hold an ‘equity instrument’**

An ‘equity instrument’ is widely defined in section 8C to mean a share in a company, including:

- an option to acquire such a share or part of a share;
- any financial instrument that is convertible to a share; and
• any contractual right or obligation, the value of which is determined directly or indirectly with reference to a share.

Second Test: the equity instrument must be acquired by virtue of employment

The equity instrument must be acquired by virtue of the employee’s employment. This means that there must be a direct or immediate link between the employment of the taxpayer and the acquisition of that equity instrument. The fact that there is a relationship between the employment of the taxpayer and the acquisition of the equity instrument will not be sufficient, as the employment (and services rendered to the employer) must be the direct cause for acquisition of the equity instrument. In the absence of such direct, immediate and primary cause, the test would not be fulfilled.

Third Test: the equity instrument must be restricted

An equity instrument becomes unrestricted when it ‘vests’ in a taxpayer for purposes of section 8C of the ITA. An unrestricted equity instrument is deemed to vest on the date that it is acquired by the taxpayer, whilst a restricted equity instrument is deemed to vest in a taxpayer when all the restrictions in respect of such equity instrument cease to have effect, or when the taxpayer disposes of such equity instrument, whichever is the earlier.

Fourth Test: The three exceptions

In order to escape a taxable dividend on a restricted equity instrument, at least one of the following three subtests must be fulfilled:

Subtest 1: In terms of this test, the restricted equity instrument must constitute an ‘equity share’, other than an equity share that would have constituted a hybrid equity instrument as defined in section 8E but for the 3-year period
The term “equity share” is defined in the ITA as a share which, neither as respects dividends nor respects capital carries any right to participate beyond a specified amount in a distribution. The use of the words “neither as respects dividends nor respects capital” indicates that both the right to dividends and the right to the capital must be restricted before a share ceases to be an equity share. Therefore, if a shareholder’s right to dividends in respect of a share is restricted but that shareholder’s right to the capital is unrestricted, the share will still constitute an equity share (and vice versa, i.e. if the capital is restricted but there is an unlimited right to dividends). On the other hand, if the right to receive both dividends and capital is restricted, the share will not be an “equity share”.

The equity share must further not constitute a hybrid equity instrument but for the 3-year period requirement. In this regard, the equity share will constitute a hybrid equity instrument if:

- that share does not rank pari passu as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes; or
- any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value or money; and
- any of the following three requirements are met:
  1. the issuer of that share is obliged to redeem that share in whole or in part; 2. that share may at the option of the holder be redeemed in whole or in part; or 3. at any time on the date of issue of that share, the existence of the company issuing that share is likely to be terminated upon
Subtest 2: In terms of this test the dividend must constitute an equity instrument as defined in the first test.

Subtest 3: In terms of this test, the restricted equity instrument must constitute an interest in a trust, and where that trust holds shares, all of those shares must constitute equity shares, other than equity shares that would have constituted hybrid equity instruments as defined in section 8E but for the 3-year period requirement. In this regard, the same test as in subtest 1 above will apply.

The application of section 10(1)(k)(i)(dd) can be illustrated as follows:

A trust acquires shares in an operating company. The trust then grants vested rights to the dividends received on these shares to the beneficiaries of the trust, who are all employees of an operating company, by virtue of their employment with the operating company.

- The vested rights of the employees constitute equity instruments for purposes of 8C (contractual rights, the value of which is determined with reference to the shares). If the vested rights are unrestricted, the dividends will be exempt, and if the vested rights are restricted, the dividends will only be exempt if the requirements of subtest 3 above are met.
- The shares held by the trust also constitute equity instruments as a result of section 8C(5)(b). The taxation of the dividends on these shares will also depend on whether the shares are restricted or unrestricted. Assuming that the shares are restricted equity instruments, the only way to escape taxation would be if the shares are equity shares but for the 3-year period as set out in subtest 1 above.
The draft of the Taxation Laws Amendment Bill ("TLAB") issued in July 2013 proposed to delete section 10(1)(k)(i)(dd) from the ITA in its entirety in order to remove the distinction between dividends received from restricted or unrestricted employee shares. It furthermore proposed that the recipient of a dividend from an equity instrument would be taxed on the dividend as ordinary income, unless the equity instrument had vested, i.e. it applied to restricted equity instruments. The draft TLAB, however, did not state which section it proposed to replace section 10(1)(k)(i)(dd) with, as the only further section it referred to under this topic was section 11(t), as referred to in more detail below.

Interestingly, the TLAB presented to Parliament during October 2013 no longer seeks to delete section 10(1)(k)(i)(dd). Instead, section 10(1)(k)(i)(dd) will remain unchanged and in force and, in addition, a new section 10(i)(k)(i)(ii) is introduced.

Section 10(1)(k)(i)(ii)

According to the Explanatory Memorandum it has become apparent that the anti-avoidance rules in respect of the conversion of salary to dividends are far too narrow as they only target dividends from non-equity shares. The Explanatory Memorandum furthermore states that many employee share schemes hold pure equity shares where the sole intent of the scheme is to generate dividends for employees as compensation for past and future services rendered to an employer, without the employees acquiring ownership of the shares. The dividends received are considered by SARS to be "disguised salaries" for employees, or remuneration for services rendered in another form even though these dividends arise from equity shares.

To address the concerns raised by SARS, it is necessary to include a specific dividend exemption under section 10 of the ITA, as an inclusion under paragraph (c) of the "gross income" definition remains futile because tax exempt dividends are
excluded from income in any tax calculation. As a result, the TLAB proposes to introduce a new section 10(1)(k)(i)(ii) from 1 March 2014 which provides that a dividend shall not be exempt from tax if such dividend is received by or accrued to a person in respect of services rendered or to be rendered or in respect of or by virtue of employment or the holding of any office, other than (i) a dividend received or accrued in respect of a restricted equity instrument as defined in section 8C held by that person or (ii) in respect of a share held by that person. An analysis of section 10(1)(k)(i)(ii) reflects the following:

- As a first test the dividend must be received or accrued in respect of services rendered or by virtue of employment. It is accepted that there is no difference between the meaning of the words “in respect of” or “by virtue of”, and the distinction is rather superfluous as both require a direct or causal relationship between the employment with the company and the declaring of the dividend. Based on the Explanatory Memorandum, this requirement suggests that the dividend must be compensation for services rendered and, therefore, a disguised salary. Put differently, where dividends are received and there is no motive to disguise such dividends as remuneration, for example as a result of the shareholding only, the requirement will not be met. What is peculiar are the examples given in the Explanatory Memorandum, as they appear to have a broad stroke and suggest that any dividend received through an employment scheme will be by virtue of employment and with no regard to the motive for the declaring of the dividend.

- The second test is that the dividend must not be received in respect of a restricted equity instrument, i.e. the dividend will only be taxed if it is received in respect of an unrestricted equity instrument. This requirement is quite strange, as according to the
Explanatory Memorandum the dividend should not be taxed in the hands of employees where, upon vesting for section 8C purposes (i.e. when the equity instrument becomes unrestricted) the equity instrument will be taxed under section 8C. Accordingly, what the Explanatory Memorandum envisages, if a restricted equity instrument will result in section 8C gains being taxed a person should not be taxed on the dividend prior to such gains arising. The result is that the TLAB proposes that no tax will be paid on dividends on restricted equity instruments. What is not clear is that if an employee is taxed under section 8C by virtue of the vesting of a restricted equity instrument, such instrument will in any event become an unrestricted equity instrument, with the result that the employee will pay tax on any further dividends paid on such instrument (unless it constitutes a share – see below). This requirement therefore only makes sense if one considers the first test, i.e. that dividends must be received as a disguised salary.

- The TLAB further states that the measure will not apply to dividends paid in respect of a share held by the employee, i.e. direct shareholders who receive dividends in terms of employee share schemes will not be affected. It is common knowledge that all dividends are paid in respect of shares. If a taxpayer holds the share directly, the taxpayer will be exempt, which means that section 10(1)(k)(i)(ii) will only apply in an indirect environment, such as employee share trusts. This means that even if the dividend is a disguised salary, if the share is held directly it will be exempt, which seems to suggest that there is no issue with receiving a disguised salary if the taxpayer holds the share directly.

Dividend Withholding Tax

Dividends payable to natural persons will subject to Dividend
Withholding Tax ("DWT") at the rate of 15%. Where dividends are included in the income of a taxpayer by virtue of section 10(1)(k)(i) of the ITA, double taxation on the dividends may occur.

The solution suggested by the TLAB is that, if dividends are received and distributed in the same tax year by an employee share trust and subject to income tax in the hands of the employee-beneficiary, DWT does not have to be withheld, and the trust can make a declaration to the relevant Central Securities Depository Participant (listed shares) or the distributing company (unlisted shares) not to withhold DWT. Where DWT has been withheld by the trust and included in the employee’s income, the trust may make the abovementioned declaration in order to receive the refund of the amount withheld and to distribute the full dividend to the employee.

Proposed dividend deductions

The Draft TLAB proposed that the company declaring the taxable dividend would be entitled to an income tax deduction equal to the amount of the inclusion. In this regard, a new section 11(t) deduction was proposed. The TLAB removed this proposed deduction in its entirety on the basis that it should discourage companies from “disguising salaries” to employees as dividends.

Issue of shares as consideration
In order for the ownership of assets to pass from a seller to a buyer it is necessary that the parties agree three essential elements: price, terms and structure. These three elements are interdependent in any transaction. For instance, after agreeing the price of a transaction, i.e. the number of rand or rand value of other consideration the seller will receive, the parties will need to agree the terms such as whether the price will be paid by means cash, debt and/or shares as well as the timing of these payments.

Commercial transactions can be structured on the basis that instead of a cash payment for the acquisition of an asset, shares are issued by the purchaser in favour of the seller, usually referred to as an “asset for share” transaction. The issue of shares as consideration will give rise to a number of tax consequences which should be considered carefully before implementing the proposed transaction. Thus, after agreeing the price and the terms the parties will need to agree the structure of the transaction, namely, whether it should be structured as a taxable or a tax-deferred transaction. That careful consideration should be given to these matters is particularly the case given the ever changing tax legislative provisions.

Of particular relevance in a taxable transaction where shares are issued as consideration for the acquisition of assets are the anti-avoidance provisions addressing value mismatches. Complex tax systems such as South Africa’s invite taxpayers to carry out certain transactions by according them special tax advantages. Yet, attempts to access these advantages might be susceptible to challenges under the general anti-avoidance rule because the transaction was motivated, at least in part, by the desire to access the tax advantage, or legislative amendments might be enacted to block such tax advantages.

According to National Treasury, schemes which allowed for shares to be issued in exchange for assets where there is a mismatch in their respective values did not trigger the appropriate amount of tax. The Income Tax Act contains a number of provisions stipulating that in specific circumstances the disposal of assets will be deemed to take place at market value. For example, paragraph 38 of the Eighth Schedule contains a deemed market value provision in circumstances where an asset is disposed of by means of a donation, for a consideration not measurable in money or for a price that is not arm’s length between connected persons. Where a formal connected person relationship is absent the buyer and seller could easily structure their transaction to fall outside the paragraph 38 market value deeming provisions.

Therefore, the anti-avoidance provisions are not limited to the Eighth Schedule. Additional anti-avoidance provisions have been inserted in the Income Tax Act to address circumstances where value is transferred without triggering the appropriate tax, specifically where the parties concerned are not “connected persons”.

- Section 490A provides that if a person acquires an asset in exchange for shares, that person is deemed to have incurred expenditure in relation to the acquisition of the asset equal to the market value of the shares issued as consideration immediately after the acquisition.
- Section 248A applies where a company acquires an asset in exchange for the issue of shares by that company and the consideration differs from the consideration that would have applied between independent persons dealing at arm’s length. If there is any mismatch in market values of the assets disposed of and the shares issued as consideration for the acquisition of the assets, then section 248A addresses any such mismatch on the basis set out below.
  - Where the market value of the assets immediately before the disposal exceeds the market value of the shares issued in consideration immediately after their issue the amount of the excess must be deemed to be a capital gain.
  - Where the market value of the shares issued in consideration immediately after that issue exceeds the market value of the assets immediately before the disposal the amount of the excess must be deemed to be a section 64D dividend that consists of a distribution of an asset in specie.

A number of questions arise from the application of the above sections in practice.

- How is the market value determined?

  The Income Tax Act does not define market value in any general provision. Instead there is a definition of market value for the specific purpose of capital gains tax. That provision defines market value as the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm’s length in an open market. The South African Revenue Service has indicated that the open market value of an asset is the best price at which an interest in the asset would have been sold unconditionally for a cash consideration assuming, amongst others, that there is no duress, that a period has elapsed for the marketing of the interest and for the sale to be concluded and that both parties to the transaction acted knowledgeably, prudently and without compulsion.

  The Income Tax Act does not prescribe which valuation methodology is the most appropriate when valuing unlisted shares. It is nevertheless likely that the South African Revenue Service will expect that a number of factors that may affect the shares’ market value be taken into account -
  - the use of a valuation method will have to be explained and demonstrated why it is an appropriate method;
  - adjustments for factors such as liquidity (at the holdings level) and degree of control and to show that these adjustments are appropriate (for instance it might be possible to benchmark a minority interest in an unlisted company against a listed company operating in a similar environment); and
  - the rights of other equity and debt holders (which may influence the market value of an ordinary share).

- When will the market value be determined?

  Interestingly, section 248A refers to the market value immediately before the disposal and section 490A refers to the market value immediately after the acquisition.

  The taxpayer should therefore appreciate that the timing for determining the market value may be different depending on the relevant section concerned.

- Is there any order of preference in the application of the relevant sections?

  The latest draft amendments to the Income Tax Act clarify that if paragraph 38 is applicable, then section 248A will not be applicable. The taxpayer concerned will therefore have to consider both provisions to determine which will be applicable to the transaction in question.

  Taxpayers will be well advised to perform a tax due diligence to ascertain the implications of entering into a transaction of this nature. The taxpayer’s commercial requirements will have to be reconciled with the tax consequences. For instance, the taxpayer may seek to minimise any capital gains tax payable or ensure that the base cost of any assets acquired is as high as possible. However, these tax requirements may not always be easily achievable given the surrounding factual circumstances when considered in conjunction with the anti-avoidance provisions contained in the Income Tax Act.

Natalie Napier – Director
scheme into sectional title – exemption from transfer duty

With effect from 1 January 2013 transfer duty is no longer payable in respect of a transaction contemplated in item 8 of schedule 1 of the Share Blocks Control Act, No 59 of 1980, whereby a right to or interest in the use of immovable property conferred by virtue of the ownership of a share in a share block company is converted to ownership of the immovable property concerned.

The amendment of s9(19) of the Transfer Duty Act, No 40 of 1949 is contained in s1 of the Taxation Laws Amendment Act, No 22 of 2102.

The exemption from payment of transfer duty in such circumstances was previously restricted to a natural person and only applied if the initial acquisition of the share was subject to duty in terms of the Transfer Duty Act. The exemption now applies in respect of any such transaction concluded on or after 1 January 2013 irrespective of whether the holder of the share is a natural or juristic person, and whether or not the transaction relating to the initial acquisition of the share was subject to payment of transfer duty at that time.

The exemption is extended further to include the acquisition by any person of a part of the immovable property of the share block company where that person had a right of use of that part of the property that was conferred on him or her by reason of the ownership of a share held in the share block company.
Consideration for the surrender of a right to acquire shares

Section 8C under the spotlight.

The South African Revenue Service (Sars) issued Binding Private Ruling 147 (ruling) on 14 May 2013. It deals with the tax treatment of compensation received by an employee for the surrender of a right to acquire shares under s8C of the Income Tax Act, No 58 of 1962 (Act).

The applicant in the ruling was the chief executive officer and managing director of a company (seller). The seller sold its business to another company (purchaser) including all its assets and liabilities as a going concern. The purchaser extended an offer of employment to the applicant, which offer contemplated that the business would be transferred to a new company (Newco), and that the applicant would be appointed chief executive officer of Newco. In terms of the offer, the applicant would also receive an equity share in Newco, which would be transferred to him following an uninterrupted 5 year employment period.

However, after the applicant accepted the offer, the applicant was informed that parts of Newco’s business would be sold to another company. Such a disposal would have the effect of decreasing the value of the applicant’s right to receive shares in Newco after 5 years.

The purchaser therefore agreed to compensate the applicant for surrendering his right to acquire shares in Newco. The compensation would be a cash amount equal to the value of the equity shares in Newco that the applicant had the right to receive in 5 years, at the time of the disposal of parts of
Newco’s business. The compensation would be paid from the proceeds of the sale of parts of Newco’s business.

Section 8C(1) of the Act provides inter alia that any gain or loss made due to the vesting of an equity instrument acquired by virtue of a taxpayer’s employment, must be included in the taxpayer’s income for the relevant year of assessment.

Sars ruled that the compensation received by the applicant for surrendering his right to acquire an equity stake in Newco would be a gain to be included in the Applicant’s income in terms of s8C(1) of the Act.

Unfortunately Sars did not elaborate on the actual operation of s8C, which could have shed some light on the inner-workings of this deceptively complicated piece of legislation.

For instance, Sars did not specifically indicate how it is that the applicant’s right to receive shares in Newco constitutes an equity instrument. It is assumed that Sars viewed the applicant’s right as falling within paragraph (c) of the definition of ‘equity instrument’ in s8C(7) of the Act, being a ‘contractual right or obligation the value of which is determined directly or indirectly with reference to a share’.

The specifics of how the applicant’s right ‘vested’ for purposes of s8C of the Act was also not discussed. In this regard it submitted that the applicant’s ‘equity instrument’ would vest in terms of s8C(3)(b)(ii) of the Act, which provides that vesting occurs in respect of a restricted equity instrument ‘immediately before that taxpayer disposes of that restricted equity instrument’.

Danielle Botha, Associate, and Heinrich Louw, Associate, Tax, Cliffe Dekker Hofmeyr
Dividends withholding tax implications where a resident company is a beneficiary of a share scheme trust

Dividends withholding tax ("DWT") was introduced into the Income Tax Act 58 of 1962 ("the Act") with effect from 1 April 2012. Section 64F of the Act exempts the withholding of DWT in respect of the receipt of dividends, to the extent that it does not consist of dividends in specie by "beneficial owners" which are listed in the section. A resident company is included in the exemption in terms of the list in section 64F(a).

We are all aware that uncertainty can arise in the determination of who the beneficial owner is in cases where a trust is the recipient of a dividend. It is trite law that the beneficiaries of a vested trust are the beneficial owners as the dividend paid would accrue to them in terms of section 25B of the Act. The trust would merely act as a conduit for the income. However, in the case of a discretionary trust this is not certain as the trustees may not have exercised their discretion to vest the right to the income in the beneficiaries.

The South African Revenue Service ("SARS") recently issued a Binding Private Ruling ("BPR 129") dealing with the exemption from dividends tax of dividends received by a listed resident company, as a result of being the beneficial owner of the thereof, that were paid in respect of the company’s own shares. Section 64D of the Act defines “beneficial owner” as
the person entitled to the benefit of the dividend attaching to a share.

The facts of BPR 129 are essentially that the Applicant Company had five share incentive schemes for its different categories of employees. The terms of each scheme were embodied in a trust deed that established a separate Share Trust. A set of scheme rules governed the operation of each particular share incentive scheme trust.

Each Share Trust regularly held shares that were not allocated to any staff beneficiary, either because a beneficiary left the Applicant Company’s employ in circumstances that required the Share Trust to repurchase the shares, or because a beneficiary of the Share Trust failed to exercise their share options, or because shares were acquired by a Share Trust and the trustees of that trust have not yet allocated the shares or awarded options to purchase them, as the case may be. The Applicant Company is also a beneficiary of all five Share Trusts.

From time to time the Applicant Company will pay dividends via a regulated intermediary (as defined in section 64D) to its shareholders, which will include the five Share Trusts, that have each acquired shares in the Applicant Company. The trustees of each Share Trust will, inter alia, resolve to allocate the dividends received on unallocated shares to the Applicant Company as a trust beneficiary.

The question which was the subject of the ruling was whether the Applicant Company was the beneficial owner of the dividends and therefore excluded from DWT in terms of section 64F. For a person to be the beneficial owner they do not necessarily require legal title to the dividend but merely have to enjoy entitlement to the benefit of the dividend. SARS ruled that the Applicant Company will be the beneficial owner of the dividends paid in respect of the unallocated shares, with the result that the exclusion in section 64F(a) of the
Executive summary
Share incentive schemes were again mentioned in this year’s tax budget proposals. It thus appears that the broad-based employee share plan contemplated in s8B of the Income Tax Act will be reviewed and possibly merged with s8C of the Income Tax Act into a single employee share scheme regime.

Full article
Share incentive schemes are once again in the spotlight in this year’s tax budget proposals. It appears that previous amendments have not satisfied Treasury’s concerns on share incentive schemes. Treasury indicates that some staff equity schemes are used as a tool to lower overall tax rates for executives and other-high-income earners. Schemes for lower income taxpayers are sometimes subject to anomalies that may give rise to double taxation.

It thus appears that the broad-based employee share plan contemplated in s8B of the Income Tax Act will be reviewed and possibly merged with s8C of the Income Tax Act into a single employee share scheme regime. Section 8B schemes are not used by many taxpayers owing to the onerous requirements. If the s8C and s8B share scheme provisions are combined, it is anticipated that it will be to the detriment of high-net worth
individuals.

It is also indicated that the interrelationship between employer deductions and employee share scheme income will be examined by Treasury. It is anticipated that one of the South African Revenue Service concerns is that taxpayers currently argue that the contributions to the employee share scheme for their employees are deductible (see Provider v Commissioner of Taxes, 17 SATC 40), while the contributions received by the Trust are capital in nature on the basis that the trust is not engaged in a profit-making scheme (see CIR v Pick ‘n Pay Employee Share Purchase Trust 54 SATC 271).

Anti-avoidance: share repurchases through subsidiaries

Judgment was handed down on 16 November 2012 by the Tax Court in the case of A Ltd v Commissioner for the South African Revenue Service. The facts were as follows.

A Ltd was a company listed on the JSE. An employee share incentive scheme was being implemented at the time (2000-2001) in terms of which shares in A Ltd would have had to be delivered to employees in future. In order to hedge against price increases, a wholly-owned subsidiary, ALS, was set up to acquire and hold shares in A Ltd. ALS subsequently acquired A Ltd shares in the open market through an interest-free loan from another wholly-owned subsidiary of A Ltd. ALS was not authorised to own more than 10% of A Ltd shares. ALS transferred the A Ltd shares to the employee share incentive trust in 2003.
A Ltd had substantial amounts of surplus cash, and would have even more if A Ltd were to sell off a subsidiary, PTS. It was proposed during 2001-2002 that, unless better investments could be found, PTS should be sold and a ‘repurchase’ of A Ltd shares be implemented as this would be good for A Ltd’s headline earnings per share.

It was understood that ALS would continue to be used to buy A Ltd shares. ALS then bought A Ltd shares in 2003. In order for ALS not to exceed the 10% limit, A Ltd bought back some of its own shares from ALS in 2004 and they were cancelled. ALS bought more A Ltd shares in 2004 and shortly thereafter A Ltd bought back more of its own shares from ALS.

Some A Ltd shares held by ALS was also disposed of by ALS to third parties in respect of other transactions. There were also further purchases by ALS of A Ltd shares in late 2004 and middle 2005.

All A Ltd shares held by ALS were sold back to A Ltd by the beginning of 2006 and cancelled. This was done in respect of a particular transaction that required a third party to acquire 100% of the issued shares of A Ltd.

In respect of each repurchase of A Ltd shares by A Ltd from ALS, the consideration payable in respect of the repurchase constituting a dividend, exemption from secondary tax on companies (STC) was claimed by A Ltd in terms of s64B(5)(f) of the Income Tax Act, No 58 of 1962 (Act). The section provides exemption in respect of dividends declared to group companies. If A Ltd directly bought back its own shares in the open market, and not through ALS, no exemption would have been available and A Ltd would have been liable for STC.

The Commissioner issued an assessment for STC to A Ltd in respect of the repurchases that took place during 2004 and 2006. The Commissioner’s case was that the exemptions were claimed pursuant to a transaction, operation or scheme
contemplated in s103(1) of the Act (as it read at the time) in order to avoid paying STC.

In respect of the application of s103, the court noted that the following needs had to be established:

Transaction: a transaction, operation or scheme was engaged in;
Effect: the effect is avoidance or postponement of tax a liability;
Abnormality: the transaction was entered into or carried out in a manner which would not normally be employed for bona fide business purposes other than obtaining a tax benefit, or created rights or obligations that would not normally be created between persons dealing at arm’s length under a transaction of the nature of the transaction in question; and
Purpose: the transaction was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.

In respect of the ‘transaction’ requirement, the court noted that the onus is on the Commissioner. In this case there were several transactions, but the Commissioner had to establish that they were steps in a single scheme of transactions or a unitary scheme. The court said that there must be sufficient unity between the earlier steps and the later steps so that it can be said that there is a unitary scheme, keeping in mind the ‘ultimate objective’. The court found that, on the objective facts, there was no such unitary scheme. This was so because ALS had initially been established for hedging purposes in respect of the employee share incentive scheme and not in respect of selling the shares to A Ltd and cancelling them. Also, even though the repurchase programme envisaged that ALS would purchase A Ltd shares, it was not contemplated that the shares would be on-sold to A Ltd and cancelled. This was only done once ALS neared its 10% limit. Also, the last batch of A Ltd shares were only sold to A Ltd and cancelled to accommodate the transaction with the third party.
The court noted that as a prerequisite or jurisdictional requirement for applying s103 of the Act, the Commissioner must be satisfied that the various requirements are met, including the ‘transaction’ or ‘scheme’ requirement. The Commissioner must “stand and fall by his reasons for exercising the power”, such as the reasons for being satisfied that the required elements were present. If the Commissioner contends in his statement of grounds of assessment that he was satisfied that there was a particular scheme, he cannot later at the hearing stage argue that he was satisfied that there was some other alternative scheme. In this case the Commissioner had always contended that he was satisfied that there was a scheme and that the scheme was the intentional interposition of ALS so that ALS could buy the shares in A Ltd and then A Ltd could buy those shares from ALS, a group company, and escape STC on the repurchase. In other words, the Commissioner saw the scheme as consisting of two steps, being the purchase of A Ltd shares by ALS and the subsequent purchase by A Ltd of those shares, and those two steps constituted one scheme. The Commissioner could not at the hearing stage accept that the first step may have been commercially justifiable, and proceed to attack only the second step, because that had never been his case. The Commissioner could not now argue that he was satisfied that there was a scheme that was different from the scheme that it had always argued it was satisfied of.

The court noted that failure to meet the ‘transaction’ requirement is sufficient cause for s103 of the Act not to be applicable, but in any event also considered the other requirements.

In respect of establishing the ‘effect’ requirement relating to the avoidance of a tax liability, the onus is on the Commissioner – the Commissioner must prove that the ‘scheme’ had the ‘effect’ of avoiding STC. The court noted that A Ltd was under no obligation to buy its own shares and it would
only do so if it made good commercial sense to repurchase its own shares. Also, the question had to be asked whether, if A Ltd had to directly purchase the shares in the open market and pay STC, it would have done so despite having to pay STC. The Commissioner did not show that that was the case.

In respect of the ‘abnormality’ requirement, the court noted that the onus is on the Commissioner. Abnormality has to be established objectively and comparisons may be made with persons in similar positions engaging in similar transactions, keeping in mind that what is abnormal as between unrelated parties may be normal as between parties with an existing special relationship. In this case it was established, partly by expert witnesses, that it is quite common for companies to hold treasury shares and to repurchase those shares.

In respect of the ‘purpose’ requirement, the court noted that the onus is on the taxpayer and that the subjective purpose of the parties is a question of fact. The purpose must at least be the dominant purpose over any other purpose. On the evidence the sole or main purpose for entering into the transactions was not to obtain a tax benefit. The purpose was to make an investment into A Ltd’s own shares by holding them in treasury and not to sell them immediately to A Ltd and to cancel them. The sale of the shares to A Ltd only happened in circumstances that were not foreseen, such as accommodating the transaction with the third party.

Accordingly the taxpayer was successful and the appeal was upheld.