The perils of share incentive schemes for employers

A lot of focus has been placed on the tax implications that flow from an employee's participation in share incentive schemes. However, employers need to be aware of the potential tax consequences that may arise where such schemes are not administered in accordance with the provisions of Income Tax Act, Act 58 of 1962 ("the Act").

The Fourth Schedule to the Act ("Fourth Schedule") places an obligation on an employer to withhold employees' tax on the remuneration paid to an employee. Remuneration is defined in the Fourth Schedule to include any gains received by or accrued to an employee by virtue of the vesting of an equity instrument as envisaged by section 8C of the Act.

Employees' tax is generally withheld from any consideration paid to the employee in respect of the disposal of an equity instrument or from any cash remuneration paid to the employee after the vesting of an equity instrument. The employees' tax should be deducted during the year of assessment which the equity instrument vests.

In many instances it appears that employers determine the amount to be withheld on the vesting of an equity instrument in the same manner as it would calculate employees' tax in any other month and it has become standard practice to merely withhold employees' tax at the maximum marginal rate applicable to the specific employee on the vesting date.

In contrast to the standard practice, paragraph 11A(4) of the Fourth Schedule provides that an employer must, before deducting or withholding employees tax in respect of remuneration derived in terms of a share incentive scheme, ascertain from the Commissioner the amount to be so deducted.

This provision places an additional administrative burden on the employer to apply for a tax directive in respect of each employee on each vesting of an equity instrument. However, obtaining the tax directive is not optional but a statutory requirement and non-compliance could lead to the imposition of penalties.

There is currently no specific provision in the Fourth Schedule which contains a penalty for the failure to obtain a tax directive, but the Fourth Schedule is subject to the general penal provisions contained in the Act.

In terms of section 75B of the Act, the South African Revenue Service ("SARS") may impose administrative penalties in respect of any non-compliance with an obligation imposed under the Act. Accordingly, the failure to obtain a tax directive before deducting the employees' tax constitutes a failure to submit a document and therefore administrative penalties may be imposed.

The potential penalty is a fixed amount calculated on a sliding scale with reference to the employer's taxable income in the previous year of assessment. For example, an employer whose taxable income exceeded R50 million could potentially be liable for a penalty of R16 000 per month, per contravention until the contravention is dealt with. However, it is important to note that it is not a once-off penalty and SARS could impose a penalty for each failure to apply for the directive i.e. in respect of each vesting in the individual participants of the share scheme.

Further, employers must note that such contraventions cannot be rectified through the Voluntary Disclosure Programme since the administrative penalties levied in terms of section 75B of the Act are specifically excluded from its scope.

Share incentive schemes are generally implemented by employers with the purpose of rewarding its employees. However, the

failure to administer such schemes as required by the Act could result in the employer incurring an unforeseen tax liability. We have not seen SARS impose administrative penalties on the basis set out above, but employers should seek directives where required under paragraph 11A of the Fourth Schedule to the Act.