

**A CRITICAL ANALYSIS OF THE TAX EFFICIENCY OF SHARE INCENTIVE SCHEMES
IN RELATION TO EMPLOYEES IN SOUTH AFRICA**

By

SAMANTHA JÖNAS

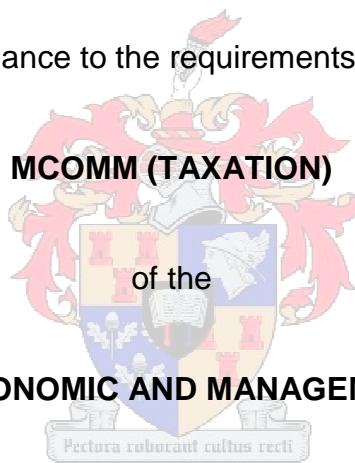
ASSIGNMENT

in partial compliance to the requirements for the degree

MCOMM (TAXATION)

of the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES



at

STELLENBOSCH UNIVERSITY

STUDY LEADER: MR HERMAN VIVIERS

DECEMBER 2012

DECLARATION

I, Samantha Jönas, declare that the entirety of this assignment is my own, original work, that I am the sole author thereof (except to the extent explicitly otherwise stated), that reproduction and publication thereof by Stellenbosch University will not infringe upon third party rights and that I have not previously submitted this assignment, in part or in its entirety, to any other university for the acquisition of any qualification offered.

S JÖNAS

31 OCTOBER 2012

ACKNOWLEDGEMENTS

I would like to express my sincere thanks to my study leader, Mr Herman Viviers, for his guidance, support and contributions during this study.

Special thanks must be given to my friends, especially Desiree Mkhonza, for their support and words of encouragement during the tough times in New York when I did not think I would be able to get through this assignment.

Most importantly I could not have completed this assignment without the generous, loving and unwavering support of my mother, Irma, my father, Marius, and my sister, Courtney. Your constant support, words of encouragement and deep belief in me kept me going through the toughest times. Words cannot describe how much you all mean to me!

A CRITICAL ANALYSIS OF THE TAX EFFICIENCY OF SHARE INCENTIVE SCHEMES IN RELATION TO EMPLOYEES IN SOUTH AFRICA

Share incentive schemes have become an important part of the remuneration package of employees in South Africa. Employers offer share incentive schemes to employees in order to attract and retain high quality workers while aligning the interests of the employees with those of the shareholders. Employees are motivated to participate in share incentive schemes due to the opportunity to invest in their financial future, as well as the opportunity to share in the economic success and growth of the employer company. Due to the increase in the utilisation of share incentive schemes to remunerate employees, the South African Revenue Service (the SARS) increased its focus on the taxation of such schemes.

Section 8C of the Income Tax Act No. 58 of 1962 (the Act) was introduced by the SARS on 24 January 2005 to govern the taxation of share incentive schemes in South Africa. Prior to the introduction of section 8C, section 8A sought to tax the gains realised by employees participating in share incentive schemes, being the difference between the market value on the exercise date and the grant price. The tax liability incurred by employees in terms of section 8A did not tax the full gain eventually realised by employees upon vesting of the shares and the SARS sought to close this loophole through the introduction of section 8C to the Act. The employer company is required by the Fourth Schedule to withhold employees' tax amounting to the gain realised by the employee in terms of section 8C of the Act.

This assignment analysed the workings of the four share incentive schemes most commonly found in the South African marketplace, namely: share option scheme, share purchase scheme, deferred delivery share scheme and phantom share scheme. The current normal income tax legislation governing share incentive schemes in relation to employees was examined by considering literature contained in the Act, amendment bills and acts, case law and other material. Based on current income tax legislation, the tax implications of each of the four selected share incentive schemes was determined and compared in order to determine which of the selected share incentive schemes are most tax efficient in relation to the employee.

It was concluded that the share option scheme and the deferred delivery share scheme are the most tax efficient schemes in relation to the employee. Based on case studies conducted, along with an analysis of the current income tax legislation contained in the Act, the share option scheme and the deferred delivery share scheme resulted in the lowest overall tax liability for employees. It was further concluded that employers will be required to revisit the structuring of their current share incentive schemes in order to ensure that any dividends paid to employees in terms of the schemes will remain exempt in terms of the amended section 10(1)(k)(i)(dd). The assignment includes recommendations relating to how share incentive schemes can be structured to be more tax efficient.

'n KRITIESE ANALISE VAN DIE BELASTINGDOELTREFFENDHEID VAN AANDELE-AANSPORINGSKEMAS MET BETREKKING TOT WERKNEMERS IN SUID-AFRIKA

Aandele-aansporingskemas het 'n belangrike deel van die vergoedingspakkette van werknemers in Suid-Afrika geword. Werkgewers bied aandele-aansporingskemas aan werknemers om sodoende hoë-kwaliteit werkers te lok en te behou terwyl die belange van die werknemers met dié van die aandeelhouders belyn word. Werknemers word gemotiveer om aan aandele-aansporingskemas deel te neem vanweë die geleentheid om in hul finansiële toekoms te belê, sowel as die geleentheid om in die ekonomiese sukses en groei van die werkgewer-maatskappy te deel. Weens die toename in die aanwending van aandele-aansporingskemas om werknemers te vergoed, het die Suid-Afrikaanse Inkomstebelastingdiens (die SAID) sy fokus op die belasting van welke skemas verskerp.

Artikel 8C van die Inkomstebelastingwet Nr. 58 van 1962 (die Wet) is deur die SAID op 24 Januarie 2005 ingestel om die belasting van aandele-aansporingskemas in Suid-Afrika te beheer. Voor die instelling van artikel 8C het artikel 8A gepoog om die winste gerealiseer deur werknemers wat aan aandele-aansporingskemas deelneem, te belas, synde die verskil tussen die markwaarde op die uitoefeningsdatum en die toekenningsprys. Die belastingaanspreeklikheid aangegaan deur werknemers ingevolge artikel 8A het nie die volle wins uiteindelik gerealiseer deur werknemers ten tye van vestiging van die aandele belas nie, en die SAID het gepoog om hierdie skuiwergat te sluit deur die instelling van artikel 8C in die Wet. Daar word van die werkgewer-maatskappy verwag om werknemersbelasting ingevolge die Vierde Bylaag te weerhou ten bedrae van die wins deur die werknemer ingevolge artikel 8C van die Wet gerealiseer.

Hierdie studie het die werking van die vier mees algemene aandele-aansporingskemas in die Suid-Afrikaanse mark geanaliseer, naamlik: die aandele-opsieskema, aandele-aankoopskema, uitgestelde-leweringskema, en die skyn-aandelekema. Die huidige normale inkomstebelastingwetgewing wat aandele-aansporingskemas ten opsigte van werknemers beheer, is ondersoek deur die literatuur in die Wet, wysigingswetsontwerpe en wette, beslissings en ander materiaal in oënskou te neem. Gebaseer op huidige inkomstebelastingwetgewing is die belastingimplikasies van elk van die vier geselekteerde aandele-aansporingskemas bepaal en vergelyk om sodoende te bepaal watter van die

geselekteerde aandele-aansporingskemas die mees belastingdoeltreffend ten opsigte van die werknemer is.

Daar is gevind dat die aandele-opsieskema en die uitgestelde-leweringskema die mees belastingdoeltreffende skemas ten opsigte van die werknemer is. Gebaseer op gevallestudies wat uitgevoer is, tesame met 'n analise van die huidige inkomstebelastingwetgewing vervat in die Wet, het die aandele-opsieskema en die uitgestelde-leweringskema gelei tot die laagste algehele belastingaanspreeklikheid vir werknemers. Daar is verder tot die gevolgtrekking gekom dat daar van werkgewers verwag gaan word om die strukturering van hul huidige aandele-aansporingskemas te hersien om sodoende te verseker dat enige dividende wat aan werknemers in terme van die skemas betaal word, vrygestel sal bly ingevolge die aangepaste artikel 10(1)(k)(i)(dd). Die studie sluit aanbevelings in oor hoe aandele-aansporingskemas gestruktureer kan word om meer belastingdoeltreffend te wees.

TABLE OF CONTENTS

CHAPTER 1: INTRODUCTION.....	2
1 Background.....	2
1.1 Share option scheme.....	4
1.2 Share purchase scheme.....	4
1.3 Deferred delivery share scheme.....	5
1.4 Phantom share scheme.....	5
2 Relevant tax legislation.....	6
3 Problem statement.....	8
4 Research objectives.....	8
5 Limitations of scope.....	8
6 Research methodology.....	9
7 Structure of the study.....	9
CHAPTER 2: LITERATURE REVIEW.....	11
1 Introduction.....	12
2 Share incentive schemes: The motivation.....	12
2.1 Agency theory and the alignment of interests.....	12
2.2 Recruitment and retention.....	14
2.3 Opportunity to invest in financial future.....	15
2.4 Employee engagement, productivity and company growth.....	15
3 Common share incentive schemes.....	16
4 The development of tax legislation relevant to share incentive schemes.....	17
4.1 Regulation prior to the introduction of section 8A.....	17
4.2 Section 8A.....	18
4.2.1 The right.....	18
4.2.2 Marketable security.....	19
4.2.3 Employment.....	19
4.2.4 The gain.....	19
4.2.5 The downfall of section 8A.....	21
4.3 Section 8C.....	21
4.3.1 Equity instrument.....	22
4.3.2 Vesting.....	24

4.3.3	Employment	24
4.3.4	The gain or loss.....	26
4.3.5	Notable provisions in section 8C	27
4.3.6	The continued development of section 8C	28
5	Tax efficiency: The definition and the measurement thereof	28
5.1	The definition	28
5.2	The measurement.....	29
5.2.1	Tax event timing and value taxed.....	29
5.2.2	Types of taxes applicable.....	29
6	Conclusion	30
CHAPTER 3: THE SHARE INCENTIVE SCHEME MECHANISM		31
1	Introduction	32
2	Share incentive scheme variables.....	33
2.1	Employee selection.....	33
2.2	The share trust.....	33
2.3	Shares or units granted	36
2.4	Cash-settled vs. equity-settled share incentive schemes	36
2.5	Vesting conditions.....	37
2.6	Share options.....	38
2.7	Option price	38
3	The four main types of share incentive schemes	39
3.1	Share option scheme.....	39
3.2	Share purchase scheme	40
3.3	Deferred delivery share scheme	41
3.4	Phantom share scheme.....	42
4	Conclusion	43
CHAPTER 4: TAX EFFICIENCY		44
1	Introduction	45
2	The primary tax legislation governing share incentive schemes: Section 8C.....	45
3	The Fourth Schedule and its impact on share incentive schemes	50
4	Seventh Schedule benefits granted in share incentive schemes	51
5	Dividends from share incentive schemes and their potential exemption	52

6	The impact of donations tax on share incentive schemes	55
7	Share incentive schemes and capital gains tax.....	56
8	Tax implications for each share incentive scheme	58
8.1	Share option scheme.....	59
8.1.1	Case study	59
8.1.2	Tax implications	60
8.2	Share purchase scheme.....	62
8.2.1	Case study	62
8.2.2	Tax implications	63
8.3	Deferred delivery share scheme.....	66
8.3.1	Case study	66
8.3.2	Tax implications	67
8.4	Phantom share scheme.....	70
8.4.1	Case study	70
8.4.2	Tax implications	71
9	Tax efficiency comparison and conclusion	73
CHAPTER 5: CONCLUSION		76
1	Introduction	76
2	The motivation of share incentive schemes	76
3	The development of tax legislation relevant to share incentive schemes	77
4	Share incentive schemes and their tax implications.....	79
4.1	Share option scheme.....	79
4.2	Share purchase scheme	80
4.3	Deferred delivery share scheme	81
4.4	Phantom share scheme.....	82
5	Conclusion and recommendation	84
BIBLIOGRAPHY		86
1	Acts, Bills, Interpretation Notes and Accounting Standards	87
2	Books	88
3	Electronic databases.....	88
4	Journal articles	88
5	Dissertations, assignments and theses	90

6	Websites	90
7	Court cases	95

LIST OF FIGURES

Figure 4.1: Timeline of the share option scheme case study	60
Figure 4.2: Timeline of the share purchase scheme case study	63
Figure 4.3: Timeline of the deferred delivery share scheme case study	67
Figure 4.4: Timeline of the phantom share scheme case study	71

CHAPTER 1: INTRODUCTION

1	Background	2
1.1	Share option scheme	4
1.2	Share purchase scheme	4
1.3	Deferred delivery share scheme	5
1.4	Phantom share scheme	5
2	Relevant tax legislation	6
3	Problem statement	8
4	Research objectives	8
5	Limitations of scope	8
6	Research methodology	9
7	Structure of the study	9

CHAPTER 1: INTRODUCTION

1 Background

Remuneration structures have transformed significantly over the last two decades (Sacho, 2003:1). There has been a shift from traditional cost-to-company pay packages to more performance-related, equity-based remuneration, such as share incentive schemes. A share incentive scheme is defined as any scheme in which employees who achieve personal or group performance targets are rewarded with shares in the company (A Dictionary of Business and Management, 2006). Initially, this change was most common in the senior levels of employees, such as senior management, executives and directors. However, such equity-based remuneration has become common in the remuneration packages of all employee levels (Sacho, 2003:1). Share incentive schemes have been widely implemented across the globe, with the United Kingdom, United States, Europe, Canada and Australia leading the way (Nyelisani, 2010:4). As early as 2001, equity-based remuneration comprised more than half of the total remuneration awarded to top executives in the United States (Sacho, 2003:1).

This change in remuneration structure has resulted in large qualitative as well as quantitative benefits for both the companies offering the share incentive schemes, as well as the employees who partake in such schemes. Qualitative benefits include employers retaining key employees, while simultaneously aligning employee financial interests with those of company shareholders (Sacho, 2003:1; Nyelisani, 2010:3). The employee is also provided an opportunity to invest in his or her financial future and is motivated to perform better within the company. By linking remuneration to employee performance, and ultimately the performance of the company, employees are encouraged to produce work of a higher quality, which could contribute to a company's economic success and increased net asset value (Sacho, 2003:1).

Other than the qualitative benefits noted above, there are also the quantitative benefits to consider. Such benefits for the employer will be the ability to stem the cashflow that would ordinarily flow through to the employee by way of a salary or bonus. Instead of the traditional cash bonus, the employee would receive equity-based remuneration, such as share options, ordinary shares, convertible debentures or phantom share units. This allows

the employer to utilise the cash within the business. The employee gains quantitatively through long-term investment income, such as dividend income and an increase in the value of the share and equity-based units over time.

Along with these benefits, there are also the tax advantages to consider. Share incentive schemes result in the employee being offered the right to acquire an equity instrument from the employer. Such equity instruments are shares in the employer company or instruments based on the share price or net asset value of the employer company. The employee is given a limited period to exercise the right before the offer lapses. During this period, it is possible that the employee will realise a gain based on the change in share price from the grant date to the exercise date. It is this gain that the South African Revenue Service (SARS) seeks to tax through legislation included in the Income Tax Act No. 58 of 1962 (hereafter referred to as “the Act”).

Section 8A was introduced into the Act by section 11 of the Income Tax Act No.89 of 1969 and sought to tax any gain realised by the employee when a right to acquire shares was obtained. Due to the limited period given to employees to accept the initial offer, the gain realised by the employee was small in relation to the eventual gain that would be realised when all vesting conditions were taken into account. Due to the existence of this loophole, the implementation of share incentive schemes by companies increased as employees enjoyed the tax benefit of a smaller tax liability on remuneration received through share incentive schemes (Sacho, 2003:1).

In order to bring the full gain made by employees in share schemes into account for tax purposes, section 8C was introduced by section 8(1) of the Revenue Laws Amendment Act No. 32 in 2004 (Republic of South Africa, 2005).

However, section 8(1) of the Revenue Laws Amendment Act No. 32 of 2004 introduced section 8C into the Act on 24 January 2005 to replace section 8A in order to limit the tax benefits employees were enjoying under section 8A. The effect of section 8C is to tax the gain realised by an employee upon vesting of the shares resulting in the full gain being taxed. Although section 8C has limited the tax advantage previously associated with share incentive schemes, employees and their companies have continued to gain tax advantages through share incentive schemes by adapting and customising traditional

schemes. Due to these tax benefits, section 8C continues to be amended and moulded to curb advantages that employees reap through the participation in such customised share incentive schemes.

The customised share incentive schemes referred to above stem from the more basic original share incentive schemes. Based on an extensive literature review, the following four share incentive schemes have been identified as the most commonly implemented share incentive schemes in South Africa, namely: the share option scheme, share purchase scheme, deferred delivery share scheme and the phantom share scheme (as found in Chapter 2, part 3). Although there are many share incentive scheme models found in practice in South Africa, this study will focus only on the four most common schemes listed above.

1.1 *Share option scheme*

The employer company offers the employee the right to acquire a fixed number of shares at a predetermined price at a fixed future date. Upon exercise of the option, the employee will be required to make full payment based on the grant price and will simultaneously receive the shares. Full ownership and benefits attached to the shares will transfer to the employee upon full payment of the grant price.

1.2 *Share purchase scheme*

A share trust is set up by the employer company with the sole purpose of administering the share purchase scheme on behalf of the employer company. The employer company will grant a loan to the share trust to acquire the shares allotted to employees and will hold such shares until such time that the employees purchase the shares. The employee is offered the right to purchase a set number of shares in the employer company from the share trust. The employee is granted a loan by the share trust to purchase the shares and will make payment on the loan over a predetermined period of time. Ownership and benefits attached to the shares, such as dividends and voting rights, are transferred to the employee at the acquisition date and any dividends accrued to the employee will be utilised to extinguish the loan from the share trust until such a time that the loan is fully repaid.

1.3 *Deferred delivery share scheme*

The deferred delivery share scheme is similar to both the share option and share purchase schemes in that the employee is offered the opportunity to acquire shares in the employer company. However, unlike the share option scheme where payment is immediate upon exercising the option or the share purchase scheme where the employee is granted a loan to acquire the shares, under the share purchase scheme the employee is afforded the opportunity to pay off the purchase price of the shares over a period of time. Therefore, there is no need for a loan in this scheme. However, unlike the share purchase scheme, ownership of the shares will only transfer to the employee upon full settlement of the purchase price. The employee will not be entitled to receive any benefits attached to the shares, such as voting rights and dividends, until ownership of the shares has transferred upon full settlement of the grant price.

1.4 *Phantom share scheme*

The phantom share scheme does not offer the employee the right to acquire shares as per the share option, share purchase and deferred delivery share schemes above. The employer company offers the employee the right to acquire units (phantom shares), the value of which is based upon the value of the underlying share capital of the employer company. No physical shares are issued in terms of the phantom share scheme. The employer may choose to grant the employee units in the phantom share scheme as a substitute to the employee's cash bonus. The units issued to the employee will entitle him or her to receive dividends on the units, as well as the right to participate in the growth of the employer company through an increase in net asset value. However, unlike the three previously discussed schemes, the units issued to employees in terms of a phantom share scheme will not carry an indefinite lifespan. The units will expire at a predetermined date in the future, at which point the employee will be paid out the market value of the share upon which the value of the unit is based, along with the proportion of the growth that the employer company has experienced since the date of the unit issuance.

2 Relevant tax legislation

Any gain realised by an employee with respect to a share incentive scheme, prior to the introduction of section 8C in 2005, will be included in the employee's gross income in terms of paragraph (i) of the gross income definition included in section 1 of the Act. In terms of section 8C, any gain realised by the employee in terms of an equity instrument will be included in the employee's gross income in terms of paragraph (c) of the gross income definition included in section 1 of the Act. Paragraph (c)(ii) specifically includes any amount received by the employee due to services rendered by such employee. However, the gain will be exempted from tax by section 10(1)(nD), which states that any gain realised by the employee prior to vesting of the equity instrument as contemplated in section 8C will be exempt.

The taxation of share incentive schemes is governed by section 8C of the Act, which replaced section 8A in January 2005. Whereas section 8A sought to tax the gain realised upon exercise of the right to acquire a marketable security, section 8C includes the gain realised by the employee upon vesting of the equity instrument. In doing so, a larger gain is included in the income of the employee as more time has elapsed from the grant date to the vesting date, resulting in a larger change in market value of the underlying equity instrument. It is also important to note that section 8C makes provision for two types of equity instruments, namely restricted and unrestricted equity instruments. The gain realised by an employee holding restricted equity instruments is only included the employee's income once all restrictions have been lifted and vesting has taken place.

The Fourth Schedule to the Act determines the amount to be withheld by the employer for employees' tax. Per paragraph (e) of the remuneration definition included in paragraph 1 of the Fourth Schedule, any gain realised by the employee in terms of section 8C of the Act is required to be included in the income of such employee. It is the duty of the employer to deduct the correct amount of employees' tax from the employee's remuneration, which should be paid over to the SARS as per paragraph 2 of the Fourth Schedule to the Act.

The Seventh Schedule to the Act regulates the benefits received by an employee by reason of their employment. Paragraph 2(a) makes provision for the taxation of any benefit

where the taxpayer has acquired any asset (in this case, the right to shares, and the related shares) for no consideration or for consideration that is less than the value (constituting the open market value) of such an asset. However, section 8A and section 8C instruments are specifically excluded from paragraphs 2(a) (ii) and (iv) of the Seventh Schedule to the Act. Should a loan be granted to the employee to purchase the equity instruments through the share incentive scheme, it is possible that paragraph 2(f) will apply. Where a low interest or interest-free loan is granted to the employee, paragraph 2(f) states that the difference between the amount of interest that the employee would have incurred at the official rate of interest and the amount of interest actually paid by the employee should be included in the employee's gross income.

Capital gains tax is set out in the Eighth Schedule to the Act. Paragraph 11(2)(j) of the Eighth Schedule determines that there will be no disposal of an asset where an equity instrument has not yet vested in terms of section 8C of the Act, while paragraph 11(2)(k) of the Eighth Schedule states that there will be no disposal where an employee cedes or releases the right to acquire a marketable security in terms of section 8A. Capital gains tax may be levied in terms of the Eighth Schedule, where an employee disposes of an equity instrument that has complied with all the vesting conditions prescribed by the employer. The capital gain to be included in the employee's taxable income upon a disposal subsequent to the vesting of the equity instrument will be the difference between the market value of the equity instrument at the time of disposal and the market value of the equity instrument upon vesting, as determined by paragraph 20(1)(h).

Prior to January 2011, dividends received by employees in terms of share incentive schemes were exempt from tax in terms of section 10(1)(k)(i). However, as from 1 January 2011, the dividend exemption contained in section 10(1)(k)(i) was amended to include specific exclusions resulting in certain dividends received in terms of share incentive scheme contemplated in section 8C no longer being exempt from tax. Section 10(1)(k)(i)(dd) states that dividends received by an employee in terms of share incentive scheme contemplated by section 8C will only be exempt if such dividends were paid in respect of restricted equity instruments that constituted equity shares (as defined in section 1 of the Act) or if such dividends constituted restricted equity instruments themselves.

For the purposes and scope of this study, consideration has only been given to the tax implications associated with the normal income tax levied by the Income Tax Act No. 58 of 1962.

3 Problem statement

This study seeks to explore two problem statements, namely:

- 1) What are the tax implications of each of the four selected share incentive schemes for an employee in South Africa, with reference to the Act?
- 2) Based on such determined tax implications, and in relation to the employee, which of the four selected share incentive schemes is most tax efficient?

The purpose of this study will be to analyse the tax implications of vesting share incentive schemes in South Africa in order to determine the tax efficiency of each type of share incentive scheme covered by this study.

4 Research objectives

The primary research objectives are as follows:

- 1) To analyse and summarise the workings of the four selected share incentive schemes.
- 2) To determine the tax efficiency of each of the four selected share incentive schemes based on the legislation contained in the Income Tax Act No. 58 of 1962.

5 Limitations of scope

The scope of this study does not include the tax implications of the selected share incentive schemes for employers and is specifically limited to employees (as natural persons). The study does not cover the workings of broad-based share incentive schemes as contemplated in terms of section 8B of the Act. In determining the tax efficiency of each aforementioned scheme, the analysis for the purposes of this study will be limited to legislation contained in the Act. No reference will be made to any other tax levied by the SARS that is not specifically included in the Income Tax Act No. 58 of 1962.

6 Research methodology

The research method followed in this study consists of a literature review along with case studies, where each of the four selected share incentive schemes is evaluated and measured to determine the tax efficiency of each scheme. Current income tax legislation, accounting standards, legal judgments, dissertations and media studies were utilised as part of the literature review.

The evaluation of the tax efficiency of each of the aforementioned share incentive schemes was achieved through:

- Identifying and researching current legislation governing such share incentive schemes in the Income Tax Act of South Africa; and
- The investigation and analysis of the four selected share incentive schemes to determine which of these schemes can be deemed to be most taxed in relation to the employee.

7 Structure of the study

Chapter 2 considers the motivation of employers offering and employees participating in share incentive schemes. This motivation of employers and employees is supported by research previously conducted, both in South Africa and globally. Additionally, the development of tax legislation governing share incentive schemes in South Africa is examined.

The mechanics of the four selected share incentive schemes are set out in Chapter 3. This chapter will analyse the functioning of each of the four selected schemes in order to determine the tax implications of each scheme, as determined in Chapter 4.

Tax legislation contained in the Act relevant to share incentive schemes will be examined in detail in Chapter 4, with specific attention being given to section 8C of the Act. A study will be done into the evolution of such legislation along with how it impacted the transformation of share incentive schemes in South Africa. Chapter 4 will determine the tax implications of each of the four selected share incentive schemes and will perform a comparison of the tax efficiency of each scheme.

Chapter 5 will conclude the study with a summary of the findings and conclusions reached by the writer with regard to the research problem.

CHAPTER 2: LITERATURE REVIEW

1	Introduction	12
2	Share incentive schemes: The motivation.....	12
2.1	Agency theory and the alignment of interests.....	12
2.2	Recruitment and retention	14
2.3	Opportunity to invest in financial future.....	15
2.4	Employee engagement, productivity and company growth.....	15
3	Common share incentive schemes	16
4	The development of tax legislation relevant to share incentive schemes.....	17
4.1	Regulation prior to the introduction of section 8A	17
4.2	Section 8A	18
4.2.1	The right.....	18
4.2.2	Marketable security	19
4.2.3	Employment.....	19
4.2.4	The gain	19
4.2.5	The downfall of section 8A	21
4.3	Section 8C	21
4.3.1	Equity instrument	22
4.3.2	Vesting	24
4.3.3	Employment.....	24
4.3.4	The gain or loss.....	26
4.3.5	Notable provisions in section 8C.....	27
4.3.6	The continued development of section 8C.....	28
5	Tax efficiency: The definition and the measurement thereof.....	28
5.1	The definition	28
5.2	The measurement.....	29
5.2.1	Tax event timing and value taxed.....	29
5.2.2	Types of taxes applicable.....	29
6	Conclusion	30

CHAPTER 2: LITERATURE REVIEW

1 Introduction

Share incentive schemes have been utilised by companies across the world as a form of remuneration for executives and employees. Nyelisani (2010:4) notes that approximately ninety-two percent of listed companies in the United Kingdom offer shares to their employees, while in the United States many executives are paid solely in shares. Europe has experienced a significant increase in the use of share incentive schemes and the utilisation of such schemes is expected to double in the course of the next five to ten years (Nyelisani, 2010:4). South Africa has not been left out of the expansion of share incentive schemes and such schemes are now considered commonplace in the business models of the country (Gad, Coetzee, Farrand, Speirs & Ellis, 2009).

Given the rapid growth in the use of share incentive schemes to remunerate employees, both at an executive level and at levels below, a question is raised regarding why companies have chosen to implement such schemes.

2 Share incentive schemes: The motivation

Over several decades, a vast amount of research has been performed related to the motivation of employers in offering and employees in participating in share incentive schemes. The motivating factors for the employer, the employee or both parties are set out in the section below.

2.1 *Agency theory and the alignment of interests*

History has shown that the interests of shareholders and those of management are not consistently in alignment (Muurling & Lehnert, 2004:372). This misalignment of interests is known as agency theory (Jensen & Meckling, 1976:309). The problem of agency theory is prevalent in companies where there is a separation between management (agents) and shareholders (principal). Directors and management have a legal duty to act in the best interests of the company (Institute of Directors of Southern Africa, 2009:5). However, this is not always the case, as Muurling and Lehnert point out (2004:372). In order to combat

agency theory, shareholders and directors have sought out various methods of remuneration to incentivise employees to make decisions that would result in the growth and success of the company. An example of such remuneration is the performance-based bonus for reaching predetermined targets. Although this incentive may result in the company experiencing an increase in profitability, there is a risk attached (Harraway, n.d.). In order to achieve the short-term increased profitability, management may be too focused on achieving short-term accounting profit targets (Muurling *et al.*, 2004:375). The company may enjoy the benefit of short-term increased profitability, but such increased accounting profits are not sustainable in the long run and may result in management taking unnecessary risks to achieve short-term targets (Harraway, n.d.).

Paragraph 168 of the King III report states that share incentive schemes should be designed in such a way as to align the interests of management with those of shareholders and should link the reward to the management's performance over a long term (Institute of Directors of South Africa, 2009:44). The King III report goes further in paragraph 174 by stating that the vesting of share incentive schemes should be conditional upon the achievement of certain performance conditions, which should be linked to factors that would enhance shareholder value and promote company performance (Institute of Directors of South Africa, 2009:44). Unlike performance-based bonuses, share incentive schemes are presented as long-term incentives, dependent upon the performance of management and employees being linked to the company performance over the long term (Harraway, n.d.).

In an attempt to mitigate such misalignment of interests, shareholders have initiated the use of share incentive schemes to motivate management to act in the best interests of the company (De La Bruslerie & Deffains-Crapsky, 2008:74; Jensen & Murphy, 1990:226). Oyer and Schaefer (2004:100) noted that by linking an employee's wealth to the value of the company, the misalignment of interests could be diminished and that employees could be motivated to make decisions that are in the company's interest.

By granting ownership rights to employees via equity-based compensation, the employer effectively shifts the employees' focus away from short-term accounting profits to long-term profitability (Muurling *et al.*, 2004:375). Management and employees would be motivated to work harder towards increasing the value of the company, thereby realising a

gain for themselves (Casey, 2002). It is this theory that has made share incentive schemes more attractive than performance-based remuneration. By offering participation in a share incentive scheme to employees, the employer is aligning its interest with those of the employees, while providing the employee with the opportunity to share in the success of the company (Loughrey, 2010:25). Share incentive schemes promote a “one firm” culture where both management and shareholders strive towards a common goal (Harraway, n.d.).

2.2 *Recruitment and retention*

The right to participate in a company’s share incentive scheme has become a common feature of the remuneration package and serves as an effective mechanism for attracting potential employees. The lack of such a right may limit the company’s ability to attract top candidates and thereby limits the competitive edge of the company in the market place (Langridge, 2009; Nyelisani, 2010:20). The inclusion of the right to participate in the company’s share incentive scheme is not reserved solely for executives. It serves as a way to attract potential employees at all levels. Share incentive schemes are considered to be a crucial tool for recruiting and retaining employees in markets where there are high levels of employee mobility (Jones, Kalmi & Mäkinen, 2006:4).

Companies recognise the employee retention potential of share incentive schemes and use such schemes to retain the intellectual property and value of its employees for a specified period of time (Spamer & Burger, 2010). Due to vesting periods attached to share incentive schemes, employees are deterred from leaving the employment of the company. By leaving the company prior to vesting, the employee would lose the value of all unvested options or units (Muurling *et al.*, 2004:382). This is due to the deferred remuneration nature of share incentive schemes. Employees will enjoy the full benefit of participation upon the fulfilment of the vesting conditions (Oyer *et al.*, 2004:110). The inclusion of ‘good leaver’ and ‘bad leaver’ clauses is common and makes separate provisions for those employees who leave employment for retirement or operational reasons, and those whose services are terminated (Du Plessis, 2005:109). In the case of ‘good leavers’, such employees may still be allowed to benefit from the scheme by exercising their options, or a portion thereof, prior to leaving the company’s employment (Milovanovic & Hoek, 2011).

Share incentive schemes are excellent remuneration tools as they encourage employee loyalty while granting employees the opportunity to share in the success of the business (Net Lawman, n.d.).

2.3 *Opportunity to invest in financial future*

One of the benefits of participating in a share incentive scheme for an employee is the opportunity to share in the success of the company. Such schemes allow the employee to benefit from their efforts and participate in the business growth when the company's share price or value increases (Spamer *et al.*, 2010) and enable the employee to benefit from the success that they are helping to create (Northern Ireland Business Info, n.d.).

Nyelisani (2010:59) found that employees considered it a rare opportunity to participate in a share incentive scheme, which could lead to future savings, investments and financial empowerment. It is for this reason that share incentive schemes are considered by employees to be one of the most sought-after types of remuneration (Barlow & McClarty, 2009:11).

2.4 *Employee engagement, productivity and company growth*

The use of share incentive schemes serves a dual purpose when it comes to productivity of employees: employees are able to feel more engaged in their work, while employers enjoy the rewards of such engagement through the increased productivity of their employees, resulting in company growth (Langridge, 2009; Loughrey, 2010; The Employee Share Scheme Specialists, n.d.).

Employee empowerment is an important feature of the share incentive scheme. Employees want to feel engaged and see the impact of their work on the success and growth of the company. By including the right to participate in the company's share incentive scheme, the employer is granting the employee the opportunity to feel engaged in his work rather than kept for service purposes (Fuller, 2010; Nyelisani, 2010:7). When an employee feels engaged, there is a positive impact on the employee's attitude and focus. Those employees with a stake in the company will be more inclined to be motivated, demonstrate loyalty and an ability to relate to the company goals (Nyelisani, 2010:9).

Through the increase in employee engagement, employers will enjoy an increase in productivity. This increased productivity will enable companies to increase the overall business performance (Loughrey, 2010).

3 Common share incentive schemes

Share incentive schemes have developed and transformed over the years in order to meet the needs of the employer, employee and legislation governing such schemes. Share option schemes were prevalent prior to the introduction of section 8A in the late 1960s (Stafford, 2005:54). Post-section 8A, employers sought out other schemes to remunerate and incentivise their employees. Such subsequent schemes included, but are not limited to, deferred delivery share schemes, share purchase schemes, convertible debenture schemes, restricted share schemes and phantom share schemes (Butler, 2005:13-18; Du Plessis, 2005:105; Nyelisani; 2010:21-22; Republic of South Africa, 2004:10; Stafford, 2005: 54-60).

Based on research and studies previously performed in South Africa, the most common share incentive schemes implemented are share option schemes, share purchase schemes, deferred delivery share schemes and phantom share schemes. Du Plessis (2005:10) points out that three of the more commonly used share incentive schemes in South Africa are the share purchase scheme, share option scheme and deferred delivery share scheme. In a study conducted by Stafford (2005:54), it was indicated that share option schemes, share purchase schemes, deferred payment schemes and phantom share schemes are commonly used schemes in South Africa. Butler focussed her study on the traditional employee share schemes found in South Africa, noting that such schemes include the traditional share purchase scheme, the share option scheme, the deferred implementation option scheme and the phantom share scheme (Butler, 2005:1, 13-18). The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 refers to the following schemes in its explanation for the necessity of section 8C: share option schemes, deferred delivery share schemes, restricted share schemes and convertible debentures (Republic of South Africa, 2004:10).

Although there are many share incentive schemes found in practice, this study will focus on the four most common identified above, namely share option schemes, share purchase

schemes, deferred delivery share schemes and phantom share schemes. Each scheme will be analysed in Chapter 3.

4 The development of tax legislation relevant to share incentive schemes

Due to the growth in the utilisation of share incentive schemes, this previously largely unregulated area has gained more exposure and has caught the attention of regulators, such as the South African Revenue Service (the "SARS"). Although various regulations are applicable to share incentive schemes, this study will only focus on regulation through income tax levied by the SARS.

4.1 Regulation prior to the introduction of section 8A

Share incentive schemes grew in popularity in South Africa due to the high individual tax rates levied by the South African Revenue Department (the Revenue) in the two decades of the 1950s and 1960s (Stafford, 2005:3). Employers saw share incentive schemes as a manner in which to remunerate their employees without them having to pay large sums of money over to the Revenue in taxes. Through the participation of employees in share incentive schemes, employees were able to take home larger remuneration packages while reducing their tax liability. This was largely attributable to the fact that there was no specific tax legislation governing share incentive schemes prior to the introduction of section 8A in 1969. Employees participating in share incentive schemes were taxed on the value of the option or right at the date of accrual. This method of taxation resulted in the difference between the grant price and the value of the option at the time of accrual being included in the employee's gross income at the time of accrual. The result of the accrual basis was that the amount taxable as part of the employee's gross income was small due to the short amount of time between the grant date and the accrual date. Profits subsequent to the accrual date would be taxed in accordance with the Eighth Schedule to the Income Tax Act (No. 58 of 1962) (the "Act) if the employee did not obtain the shares with the intention of entering into a scheme for profit-making (Stafford, 2005:7).

Based on the tax legislation prior to the introduction of section 8A, employees would benefit financially from the light tax burden attached to share incentive schemes. Employees would effectively pay very little tax on a large financial benefit and potentially

valuable right (Stafford, 2005:6). Based on this legislation, it was important to determine when the accrual took place, as this would determine when the value of the option would be taxed. The longer the period from the grant date to the accrual, the bigger the potential tax liability. This loophole in tax legislation was closed as from 1 June 1969, when section 8A was introduced into the Act by section 11 of the Income Tax Act No. 89 of 1969.

4.2 Section 8A

Section 8A sought to tax any gain made by the employee when a right to acquire shares was exercised, rather than at the time of accrual of such right. This method of taxation resulted in the period between the grant date and the exercise date being longer, with more time for market value growth. This resulted in a larger potential tax liability than was the case under the previous legislation (Stafford, 2005:10).

According to the special inclusion paragraph (i) of the gross income definition in section 1 of the Act, any amount determined in terms of section 8A is required to be included in the gross income of the employee (Republic of South Africa, 1962). Section 8A(1)(a) provides that any gain made by the employee by the exercise, cession or release of any right to acquire any marketable security should be included in the employee's income if such a right was obtained by the employee in respect of services rendered by him as an employee to an employer (Republic of South Africa, 1962). Such a gain will only be included in the employee's income if it was made by the employee after 1 June 1969 and the right was obtained by the employee prior to 26 October 2004.

4.2.1 The right

The right referred to in section 8A(1)(a) is not only limited to the right to acquire options in a share option scheme, as evidenced by the judgment delivered in the *Kirsch* case. It was held that the word "right" used in section 8A should be interpreted in its wider general meaning and relates to both the right to acquire shares through options and the right to acquire shares directly (Secretary for Inland Revenue v *Kirsch*, 40 SATC 95:96; Stafford, 2005:17).

4.2.2 Marketable security

Section 8A(10) defines a marketable security for the purposes of section 8A as follows:

Any security, stock, debenture, share, option or other interest capable of being sold in a share-market or exchange or otherwise.

Per the definition above, section 8A deals with shares and similar instruments and does not deal with options to acquire other assets, such as land or inventory.

4.2.3 Employment

In order for section 8A to apply, the employee must have received the right to acquire marketable securities by virtue of employment, his office as a director of the employer or in respect of services rendered or to be rendered to the employer as an employee. If the causal link between the right and employment is missing, the gain will not be covered by section 8A. In *Income Tax Case No. 1493* (Income Tax Case No. 1493, 53 SATC 187:191), a director was granted rights in his capacity as a shareholder. Because the right was granted to him not in his capacity as a director but as a shareholder, the court held that section 8A did not apply. It was held that:

There must be a causal link between the granting of the right and the holding of the position of director or former director and the future or past rendering of services as an employee to an employer; it is a right that must be granted to the taxpayer in his capacity qua director or qua employee.

It is this causal link that excludes rights obtained by other parties, such as independent contractors, from the scope of section 8A (Stafford, 2005:24).

4.2.4 The gain

The employee is deemed to have realised a gain upon the exercise of a right to acquire a marketable security when the market value of such marketable security, at the time of

exercise, exceeds the consideration given by the employee to acquire such right at the grant date. For the purposes for section 8A(2)(a), market value is the sum that a person having the right to freely dispose of the security might reasonably expect to obtain in a sale of such a security in the open market (Republic of South Africa, 1962).

Any gain made by the employee on the exercise, cession or release of a right to acquire a marketable security will be deemed to be made at the time of such exercise, cession or release and will be included in the employee's income in such year of assessment. The exercise date is taken to be the date on which the employee completes the formalities required to exercise the right, rather than the date upon which he can deal in the securities on the stock exchange (De Koker & Williams, 2011).

Section 8A(1)(b) provides an exception to the rule set out in section 8A(2)(c), stating that where a restriction is placed on the disposal the marketable security in the year of assessment when the exercise of the right takes place, the gain will be included in the income of the employee in the year when such restriction is lifted (Republic of South Africa, 1962). Should the employee choose to defer the inclusion of the gain as per section 8A(1)(b), the employee is required to inform the Commissioner in writing no later than the date of the employee's return of income for the year of assessment in which the exercise of the right took place (Republic of South Africa, 1962; Stafford, 2005:19).

Section 8A(6) sets out the anti-avoidance provision of section 8A by preventing the employee from avoiding tax if the gain is made by any other person (Haupt, 2012:644; Stafford, 2005:21). If the employee cedes the right to acquire marketable securities to any other person in a cession that is not at arm's length, the gain will be included in the employee's income as per section 8A(1). The same rule will apply to gains made by relatives of the employee pursuant to section 8A(6)(b)(ii) (Republic of South Africa, 1962). Additionally, per section 8A(6)(a), if such a right was obtained by any other person due to the employee's office as a director of the employer, or due to services rendered to the employer as an employee, the resulting gain will be included in the employees income (Republic of South Africa, 1962).

4.2.5 *The downfall of section 8A*

Although section 8A eliminated a large portion of the tax benefits employees were enjoying prior to 1969 when gains made under share incentive schemes were largely untaxed, the Revenue (subsequently known as the South African Revenue Service) did not completely eliminate the tax relief experienced by employees in respect of such schemes (Republic of South Africa, 2004:10). Share incentive schemes were set up in such a manner that the period between the grant date and the exercise date was shortened. This shortened period resulted in the market value growth of the right, and the subsequent gain, being small in relation to the eventual gain that would be made when all vesting conditions and restrictions are taken into account (Stafford, 2005:28). In order to bring the full gain made by employees in share schemes into account for tax purposes, section 8C was introduced by section 8(1) of the Revenue Laws Amendment Act No. 32 in 2004 (Republic of South Africa, 2005).

4.3 *Section 8C*

The introduction of section 8C on 24 January 2005 is the latest attempt by the SARS to curb the tax benefits enjoyed by employees participating in share incentive schemes (Blair, 2012; Lewis, 2011a). Section 8C(1) states that the employee must include any gain in or deduct any loss from his or her income in respect of the vesting of any equity instrument acquired by the employee under the following circumstances:

- By virtue of his or her service of office of director;
- From any person as a result of an arrangement with his employer; or
- By virtue of the fact that the employee held other restricted equity instruments.

Such a gain or loss will only be included in the employee's income, regardless of the provisions of sections 9B, 9C and 23(m), if it was made by the employee on or after 26 October 2004 (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks & Swardt, 2012:391; Republic of South Africa, 1962). The inclusion of section 8C results in the acquisition of all restricted equity instruments being treated in the same manner as share appreciation rights (Republic of South Africa, 2004:10).

Section 8C shifts the focus away from when the employee takes ownership of a share or option in terms of a share incentive scheme and places the emphasis on when the equity

instrument will vest in the employee (Butler, 2005:7; Stafford, 2005:30). Any gains or losses made on equity instruments held by the employee prior to vesting will be exempt from tax in terms of section 10(1)(nD) of the Act (Republic of South Africa, 1962). This is an important change from the prior section 8A regime, as it specifically excludes gains made upon the exercise of an equity instrument. Any gains or losses per section 8C will be included in the employee's income rather than gross income as was the case with section 8A (Stafford, 2005: 38).

4.3.1 *Equity instrument*

Section 8C inserted the term "equity instrument" rather than the term "marketable security" used in section 8A. Section 8C(7) defines an equity instruments as:

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

The definition for an equity instrument is much broader than that of a marketable security. It encompasses shares, member's interest in a close corporation, share options, and any other financial instrument that derives its value with reference to an equity share, such as a convertible debenture or a phantom unit (Stiglingh *et al.*, 2012:391).

A further distinction is made by section 8C in terms of a restricted equity instrument versus an unrestricted equity instrument. The reasoning for the inclusion of the restricted equity instrument definition in section 8C is due to the nature and intention of share incentive schemes. As discussed under part 2 above, employers use share incentive schemes as a mechanism to retain employees while aligning the interests of the employer and the employee. In order to retain the employees for a period of time, the employer will place restrictions on the equity instruments. These restrictions will serve to keep the employee bound to the employer for a specified amount of time (Stafford, 2005:34). The SARS recognised this characteristic in the writing of section 8C.

Section 8C(7) defines an unrestricted equity instrument as an equity instrument that is not a restricted equity instrument (Republic of South Africa, 1962). The definition of a restricted equity instrument is more complex. A restricted equity instrument is an equity instrument with one or more restrictions placed upon it. Section 8C(7) (Republic of South Africa, 1962) determines that the following equity instruments will be restricted equity instruments:

- An equity instrument containing a restriction preventing the employee from disposing of the equity instrument at fair market value at any point in time;
- An equity instrument where financial penalties are imposed for non-compliance of agreement terms in relation to the acquisition of such equity instrument;
- An equity instrument where forfeiture of ownership can be compelled or the right to acquire ownership of such equity instrument at a value other than market value can be imposed;
- An equity instrument where any person has retained the right to impose a disposal or forfeiture restriction as contemplated by restricted equity instrument definition paragraphs (a) and (b) of section 8C(7);
- An option per paragraph (a) of the equity instrument definition contained in section 8C(7), which is only convertible to a restricted equity instrument;
- Any financial instrument per paragraph (b) of the equity instrument definition contained in section 8C(7), which is only convertible to a restricted equity instrument;
- An equity instrument, in terms of which the employer, an associated institution or other person by agreement with the employer has undertaken to cancel or repurchase the equity instrument at more than market value should there be a decline in the value of the equity instrument after the acquisition date;
- An equity instrument that is not deliverable to the employee until after the happening of a specified event, whether fixed or contingent.

As per Interpretation Note number 55, the distinction between an unrestricted equity instrument and its restricted counterpart is important as it determines the timing of the taxable event (Republic of South Africa, 2011).

4.3.2 Vesting

One of the fundamental changes made from section 8A to section 8C was the introduction of the vesting concept. In terms of section 8C, the employee will only include a gain or loss in the calculation of the tax liability once the equity instrument has vested (Stiglingh *et al.*, 2012:392; Haupt, 2012:647). In terms of section 8C(3) (Republic of South Africa, 1962), an unrestricted equity instrument will vest at the time of acquisition, while a restricted equity instrument will vest at the earliest of the following:

- When all restrictions resulting in the “restricted equity instrument” status have ceased to exist;
- Immediately before the disposal of the “restricted equity instrument” by the employee, unless the equity instrument is exchanged for another equity instrument or is sold to a connected person;
- Immediately after the termination of an option that qualifies as a “restricted equity instrument”;
- Immediately before the death of the employee if all restrictions relating to the “restricted equity instrument” were lifted on or after death;
- The time a disposal occurs as contemplated in section 8C(2)(a)(i) or (b)(i).

4.3.3 Employment

As is the case with section 8A, the employee must have acquired the equity instruments by virtue of employment, or from his or her office as a director of the employer. However, section 8C(1)(a) casts a wider net in respect of employment. Unlike section 8A, section 8C includes equity instruments obtained by the employee from any person via an arrangement with the employee’s employer, as well as from any associated institution in relation to the employer. Should the employee acquire equity instruments from a person employed by his or her employer or employed by an associated institution related to the employer, these equity instruments will be covered in terms of section 8C(1)(a)(iii) (Republic of South Africa, 1962). Based on section 8C(1)(a), it is clear that there must be a causal link between the acquisition of the employee’s equity instruments and employment (Stafford, 2005:31).

Section 8C defines both an employer and an associated institution as that contemplated in paragraph 1 of the Seventh Schedule (Republic of South Africa, 1962). Employer and associated institution are defined in the Seventh Schedule as follows:

"employer" means any person who is an employer as defined in paragraph 1 of the Fourth Schedule and includes--

- a) any company; and*
- b) for the purpose of paragraph 2 and the determination of the cash equivalent of the value of any taxable benefit granted to any person who derives remuneration as defined in the said paragraph from employment in the public service or any administration or undertaking of the State or who holds office under the Republic, the State.*

"associated institution", in relation to any single employer, means--

- a) where the employer is a company, any other company which is associated with the employer company by reason of the fact that both companies are managed or controlled directly or indirectly by substantially the same persons; or*
- b) where the employer is not a company, any company which is managed or controlled directly or indirectly by the employer or by any partnership of which the employer is a member; or*
- c) any fund established solely or mainly for providing benefits for employees or former employees of the employer or for employees or former employees of the employer and any company which is in terms of paragraph (a) or (b) an associated institution in relation to the employer, but excluding any fund established by a trade union or industrial council and any fund established for postgraduate research otherwise than out of moneys provided by the employer or by any associated institution in relation to the employer.*

Based on the above definitions, it can be seen that where an employee acquired equity instruments from an employer's share trust, the acquisition would fall into the net cast by section 8C(1)(a)(iii) as the share trust will be an associated institution in relation to the employer.

4.3.4 *The gain or loss*

The introduction of section 8C included a benefit for employees in that it allowed the employee to deduct any loss made by the employee in the vesting of equity instruments under section 8C from his or her income. Section 8A never made such a provision as it was understood that a loss would never be made on an option as the employee would not exercise the option if it was not in cash. However, per section 8C it would be possible to incur such a loss due to the vesting nature of the section.

Gains and losses are calculated in one of two ways for the purposes of section 8C(2). If a disposal is made to the employer, an associated institution or any other person by arrangement with the employer, in terms of a restriction imposed, for less than market value, the gain will be calculated as the amount received for the disposal less any consideration given by the employee. The same calculation will apply where there is a disposal of an option or convertible financial instrument by way of release, abandonment or lapse (Haupt, 2012:648; Stiglingh *et al.*, 2012:392; Republic of South Africa, 1962). Should the above two scenarios not apply, the gain or loss will be calculated as the market value of the equity instrument less any consideration given by the employee for such equity instrument (Haupt, 2012:649; Stiglingh *et al.*, 2012:392; Republic of South Africa, 1962).

The definition for market value in relation to an equity instrument is split between what is considered market value for private companies and market value for all other companies as per section 8C(7). Due to the nature of a private company, the fair value of its equity instruments is not readily available in the market. It is for this reason that the definition for market value in section 8C(7) makes provision for a different determination of market value for a private company. For a private company, market value can be determined through the use of a formula if such a formula is consistently utilised to determine the consideration to be paid for the equity instrument by the employee as well as the fair value at disposal or vesting (Haupt, 2012:649; Republic of South Africa, 1962). The market value for any other company is the price that can be obtained for the equity instrument in an arm's length transaction on the open market between a willing buyer and seller (Republic of South Africa, 1962).

Section 8C(7) provides a definition of consideration in relation to an equity instrument. Consideration for the purposes of section 8C is any amount given by the employee, other than by services rendered or to be rendered, in respect of such equity instrument. However, an anti-avoidance provision was added to the definition whereby the employee will only be entitled to deduct a limited amount as consideration if the equity instrument is disposed of to a connected person in relation to the employee or to any other person in a transaction for less than arm's length market value. In such a case, consideration will be limited to the amount the employee would have been entitled to deduct if the disposal had not taken place (Republic of South Africa, 1962).

4.3.5 Notable provisions in section 8C

Section 8C(4) provides for cases where a restricted equity instrument is disposed of for another restricted equity instrument. In such cases, the new restricted equity instrument is deemed to have been acquired by the employee by virtue of his or her employment or office as a director of the employer. Should the employee receive an additional payment in the disposal, such payment is deemed to be consideration for the disposal by the employee and will be included in his or her income as per section 8C(4)(b) (Republic of South Africa, 1962).

An anti-avoidance provision is inserted in section 8C by subsection (5)(a), which provides for disposals made by the employee in a non-arm's length transaction or made to a connected person in relation to the employee (Republic of South Africa, 2004:16). In such cases, the resulting gain or loss is included in the employee's income as if the disposal had taken place at arm's length in the normal course of business. However, if the employee disposes of the restricted equity instrument to his employer, due to a restriction imposed on the employee's rights of disposal, at an amount less than market value, the anti-avoidance provision of section 8C(5)(a) will not apply. The employee will be taxed on the gain or loss resulting from the amount paid by the employer less any consideration given by the employee at the acquisition of the restricted equity instrument (Republic of South Africa, 1962).

Through the inclusion of section 8C(5)(b), the employee will not be able to avoid the inclusion of a gain or loss in respect of section 8C in cases where any other person

acquires restricted equity instruments by virtue of the employee's employment or office as a director of the employer. Such equity instruments are deemed to have been acquired by the employee and any subsequent gain or loss on disposal will be included in the employee's income (Republic of South Africa, 1962).

As from 1 April 2012, any return of capital received by the employee in respect to a restricted equity instrument must be included in the income of the employee in the year of assessment in which the return of capital is received or accrued. However, section 8C(1A) does not apply to the capital distribution of an equity instrument (Haupt, 2012:649; Republic of South Africa, 1962; Stiglingh *et al.*, 2012:395).

4.3.6 *The continued development of section 8C*

The inclusion of section 8C in the Act has shown the intent of the SARS to limit the tax benefits previously enjoyed by employees participating in share incentive schemes. This is shown in the Explanatory Memorandum on the Revenue Laws Amendment Bill issued by the SARS in 2004 (2004:16), which states the following:

The main purpose of section 8C is to defer the taxation of restricted equity instruments until a later date so that the full level of gain on the instrument (which effectively amounts to disguised salary) is properly taxed at ordinary rates.

Since its introduction in 2005, the SARS has continued to mould and modify section 8C to close any remaining loopholes in legislation exploited by innovative share incentive schemes (Republic of South Africa, 2010a:17).

5 Tax efficiency: The definition and the measurement thereof

5.1 *The definition*

In order to determine which share incentive scheme covered by this study is most tax efficient for the employee, tax efficiency must first be defined. The Oxford Advanced Learner's Dictionary defines efficiency as the quality of doing something well with no waste

of time or money (Oxford University Press, 2011). Investopedia.com defines tax efficiency as an attempt to minimise tax liability when given many different financial decisions (2012).

For a share incentive scheme to be tax efficient, the employee would need to enjoy tax benefits by participating in the scheme. The term “tax benefit” is defined in section 1 of the Act as including any avoidance, postponement or reduction of any liability for tax (Republic of South Africa, 1962). Based on the definitions above, the tax efficiency of each of the four selected share incentive schemes (as determined in part 3 above) will be determined by evaluating the amount of the tax liability attracted by the specific scheme in relation to other share incentive schemes.

5.2 *The measurement*

In order to determine the tax efficiency of each scheme, the timing of each tax event occurring during the lifespan of the share incentive scheme will be analysed, along with the value to be taxed at each of the tax events. The implications of the various tax legislation governing share incentive schemes will be considered and evaluated to determine the level of the tax benefit enjoyed by the employee participating in the share incentive scheme.

5.2.1 *Tax event timing and value taxed*

The timing of the tax event for the employee is important as it will determine the value that will be taxed. To facilitate a high level of tax efficiency, the share incentive scheme would have to be set up in such a way that the tax event occurs as early as possible to lower the tax liability and increase the tax benefit for the employee (Barlow *et al.*, 2009:13).

5.2.2 *Types of taxes applicable*

This study focuses only on the taxes administered by the Act and specifically excludes the impact of the Valued Added Tax Act (No. 89 of 1991). The impact of the following taxes, as included in the Act (Republic of South Africa, 1962), will be assessed for each share incentive scheme in order to determine the potential tax liability under each scheme:

- Normal income tax
- Donations tax (sections 54 to 64)
- Employees' tax (Fourth Schedule)
- Fringe benefits (Seventh Schedule)
- Capital gains tax (Eighth Schedule)

6 Conclusion

Share incentive schemes have been utilised by employers to attract, retain and motivate employees for years. Due to this extensive utilisation, the SARS has taken notice of such schemes and have sought to reduce the tax benefits that employees participating in such schemes have enjoyed. Employers have had to become creative in the structuring of their share incentive schemes in order to preserve the tax efficiency for employees (Croome, 2003). Chapter 3 seeks to investigate and analyse the characteristics of the four share incentive schemes selected for this study, while Chapter 4 will evaluate the tax efficiency of each of these schemes to determine which scheme will be most tax efficient for employees given current tax legislation contained in the Act.

CHAPTER 3: THE SHARE INCENTIVE SCHEME MECHANISM

1	Introduction	32
2	Share incentive scheme variables.....	33
2.1	Employee selection.....	33
2.2	The share trust.....	33
2.3	Shares or units granted	36
2.4	Cash-settled vs. equity-settled share incentive schemes	36
2.5	Vesting conditions.....	37
2.6	Share options.....	38
2.7	Option price	38
3	The four main types of share incentive schemes	39
3.1	Share option scheme.....	39
3.2	Share purchase scheme.....	40
3.3	Deferred delivery share scheme.....	41
3.4	Phantom share scheme.....	42
4	Conclusion	43

CHAPTER 3: THE SHARE INCENTIVE SCHEME MECHANISM

1 Introduction

Over the last two decades, the use of share incentive schemes has become a common and popular basis of remuneration for executives and employees. Originally, such incentive schemes were introduced to lighten the tax burden of employees due to the high level of individual tax rates (Stafford, 2005:3). However, employers noted that share incentive schemes served a dual purpose – employers were able to retain employees, while such employees were simultaneously given the opportunity to invest in their financial future (Spamer *et al.*, 2010). In order to ensure that employees do not leave the employer, the share incentive scheme would offer such employees the opportunity to participate in the success of the company. By granting certain employees a stake in the business, such employees will acquire a vested interest in the company's performance and growth, which will align the interests of the employer to those of the employee (Ownership Solutions, 2012; Sacho, 2003:1). This alignment of interests contributed to the share incentive scheme becoming an essential part of remuneration models seen across the globe (Nyelisani, 2010:4; Sacho, 2003:1).

Share incentive schemes have taken on many forms over the last two decades. A metamorphosis has taken place, transforming previously simple schemes, such as the share option scheme, into complex and carefully structured mechanisms for remunerating employees, such as the phantom share scheme (also known as the share appreciation rights scheme) (Blair & De Beer, 2006). All four selected share incentive schemes under review, although fundamentally different as a whole, have certain variables in common. Such variables include the following:

- Employee selection
- The share trust
- Shares or units granted
- Cash-settled vs. equity-settled share incentive schemes
- Vesting conditions
- Share options
- Option price

The next section explains these variables and will provide the basis to understand these variables in order to analyse the four selected share incentive schemes in Chapter 4 to follow.

2 Share incentive scheme variables

2.1 Employee selection

The selection of employees is the prerogative of the employer, provided that the selection process does not constitute unconstitutional discrimination (Gad *et al.*, 2009; Milovanovic *et al.*, 2011). In early share incentive schemes, the privilege to participate was reserved exclusively for top management and executives (Jones *et al.*, 2006). However, as the share incentive scheme evolved, so did the selection of employees. In South Africa, the introduction of Black Economic Empowerment (“BEE”) in terms of the Broad-Based Black Economic Empowerment Act No. 53 of 2003 resulted in many companies using share incentive schemes to increase and improve their BEE compliance ratings. Employers also chose to use such schemes to reward specific project teams when achieving predetermined targets (Anon, 2012).

The most common participation selection criterion applied by employers is the time and performance measurement basis (Casson, n.d.; Gad *et al.*, 2009; Blair, 2012). The employer sets certain time and/or performance criteria to be met in order for the employees to become eligible for participation in the share incentive scheme. Therefore, should an employee not fulfil the criteria, that employee will automatically not be eligible for participation. However, as stated above, the ultimate selection for participation lies with the employer.

2.2 The share trust

The *inter vivos* share trust was designed for use in share incentive schemes in order to legally circumvent provisions in terms of the now repealed Companies Act No. 61 of 1973 and to govern the management of share incentive schemes (Butler, 2005). In terms of section 38 and section 226 of the old Companies Act, an employer company was not prohibited from providing financial assistance to a share trust for the purchase of shares in

itself. It is this characteristic of a share trust that made it particularly appealing to companies wishing to provide financial assistance to executives participating in share incentive schemes as section 226 explicitly prohibited the granting of financial assistance to company directors.

With the introduction of the revised Companies Act No. 71 of 2008, the restrictions on the granting of financial assistance, as it relates to share incentive schemes, were lifted by section 97. For the purposes of section 97, section 95(1)(c) (Republic of South Africa, 2008) defines an employee share scheme as follows:

A scheme established by a company, whether by means of a trust or otherwise, for the purpose of offering participation therein solely to employees, officers and other persons closely involved in the business of the company or a subsidiary of the company, either—

- i) by means of the issue of shares in the company; or*
- ii) by the grant of options for shares in the company.*

The insertion of section 97 lifted the prohibition placed on the granting of financial assistance to directors as contemplated in section 45, as well as the prohibition placed on granting loans to employees to purchase shares in the employer company as contemplated in section 44. However, the employer company needs to adhere to the provisions of section 97(1) in order to qualify for the exemptions provided by sections 44(3)(a)(i) and 45(3)(a)(i). Section 97(1)(a)(ii) determines that the employer company must disclose the number of shares allocated to the share incentive scheme during the financial year in its annual financial statements.

Section 97(1) states that the employer is obliged to appoint a compliance officer to oversee the share incentive scheme. Such compliance officer needs to be accountable to the employer company's board of directors per section 97(1)(a)(i), and must comply with the provisions set out in section 97(2). For the purposes of section 97, section 95(1)(b) defines a compliance officer as follows:

A compliance officer appointed by a company in respect of its employee share scheme.

Should the employer company comply with the provisions for section 97, the employer would be permitted to grant financial assistance to its employees, including directors, in order for them to purchase shares in the employer. This change in the Companies Act would seem to render the use of share trusts null and void. However, the trustees of share trusts can be appointed as compliance officers, thereby fulfilling the requirement set by section 97(1)(a)(i). The trustees would be required to comply with the requirements set out by section 97(2) relating to the responsibilities of the compliance officer.

The trustees are responsible for the administration and management of the share trust. The responsibilities of the trustees are contained in the trust deed, as well as the terms and conditions of the share incentive scheme (Butler, 2005:12). These include, but are not limited to, the following terms and conditions relating to:

- The granting of share options to selected employees for share option schemes;
- The initiation of offers to purchase shares in the case of share purchase schemes and deferred delivery schemes;
- The allocation of voting rights linked to the shares or units granted to the employees;
- The rights to receive dividends based on the shares or units granted to the employees;
- The administration of share disposal, as well as sales pricing, upon employee resignation or termination; and
- Loans granted to employees for the purchase of shares or units in the share incentive scheme. These terms and conditions will include the rate of interest related to the loans as well as repayment terms.

The share trust would be set up by the employer with the express purpose of acting as a conduit between the employer and the employees. Therefore, the share trust would not perform any other function such as producing income or acting as a tax shelter. The main responsibility of the share trust would be to hold shares for the benefit of the employees selected to participate in the share incentive scheme (Milovanovic *et al.*, 2011; Spamer *et al.*, 2010). Such shares may be acquired directly from the employer via newly issued share capital or via purchases from existing shareholders (Butler, 2005:12). The share trust would in turn pay for such shares through financing in the form of a loan (Butler, 2005:12).

Depending on the share incentive scheme, employees may obtain financing from the share trust to pay for the options, shares or units. In such cases, the employee will be required to pledge the shares obtained as collateral for the repayment of the loan (Du Plessis, 2005:105; Butler, 2005:12). Any dividends earned by the employee from such shares will be allocated to the repayment of the loan, first to the interest owing and secondly to outstanding capital. The repayment of the loan received by the share trust from the employee will be utilised by the share trust to repay any financing obtained from the employer (Butler, 2005:12). The financing position demonstrated above illustrates the share trust's primary purpose; that of acting as a conduit between the employer and employee.

2.3 *Shares or units granted*

In a share incentive scheme, it is not necessarily always true that the shares granted are those of the employer. Although this is most often the case, there are schemes where the employer will offer shares in its subsidiary companies or even in fellow group companies.

In phantom share schemes, as discussed in part 3.4 below, the participating employee is offered a right to take up units, the value of which is based on the value of the employer company's share. These units are offered to the employee in the place of actual shares (Milovanovic *et al.*, 2011). This type of scheme is considered to be a cash-settled share incentive scheme rather than a classic equity-settled share incentive scheme.

2.4 *Cash-settled vs. equity-settled share incentive schemes*

Share incentive schemes can take on two characteristics when it comes to the settlement made to employees. Employers may choose to grant the employee the right to acquire actual shares, in which case it would be an equity-settled share incentive scheme (IFRS Foundation, 2010:A111). Alternatively, the employer may grant the employee the right to acquire cash or any other asset, the value of which is based on a specific share (which could be either the employer's equity share capital or that of another group company). This type of scheme is referred to as a cash-settled share incentive scheme (IFRS Foundation, 2010:A111).

2.5 Vesting conditions

Vesting conditions are conditions that must be fulfilled by the selected employee in order for such an employee to qualify for the share options, shares or units (Icely, 2012; Milovanovic *et al.*, 2011). International Financial Reporting Standard 2 Share-Based Payment (IFRS Foundation, 2010:A113) defines vesting conditions as follows:

The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement.

The employer may choose to implement such conditions in order to retain the employee for a specific period of time or motivate the employee to act in the best interests of the company and achieve the objectives of the business.

There are two kinds of vesting conditions, namely performance and service conditions (IFRS Foundation, 2010:A113). A service vesting condition requires the employee to remain employed by the company for a specified period of time (IFRS Foundation, 2010:A113), and this condition is used primarily to retain employees.

A performance vesting condition may further be split into either a market condition or a normal performance condition (IFRS Foundation, 2010:A113). Per Appendix A of IFRS 2 (Defined terms) (IFRS Foundation, 2010:A112), a market condition is defined as:

A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instrument, such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities.

Alternatively, a normal performance condition relates to an employee's personal performance as well as to the performance of the company in reaching predetermined performance targets, such as a set net profit. In order to reach such targets, it is also

required for the employee to remain in the company's service for a specified period of time (IFRS Foundation, 2010:A113).

The use of vesting conditions has become customary in modern-day share incentive schemes in order to achieve the objectives of the employer (Barlow *et al.*, 2009). The addition of performance conditions in particular has become a growing international trend, one that South Africa is adopting (Blair, 2012; Icely & Dicks, n.d.). By incorporating vesting conditions into the share incentive scheme, the employer is able to grant employees the opportunity to invest in their financial future by sharing in the employer's growth, while aligning the interests of the employees with those of the employer and its shareholders (Spamer *et al.*, 2010; Scholtz, 2009:58 & 71). The service vesting condition enables the employer to benefit from the value of retaining employees over a specified period of time (Spamer *et al.*, 2010; Langridge, 2009).

2.6 *Share options*

The Business Dictionary defines a share option as a right to buy or sell shares at an agreed price at a time in the future (BusinessDictionary.com, n.d.). A share option is granted to an employee in a share option scheme (discussed in part 3.1 below). It grants the employee the right, without any obligation, to purchase a set number of shares for a specified price at a specific point in the future (Casson, n.d.; Bradley, Lynch, Jacobsen & O'Brien, 2012; Net Lawman, n.d.).

2.7 *Option price*

The option price is the price attached to the option granted to an employee to acquire shares within the share incentive scheme. The option price is also known as the grant price, exercise price or strike price (Anon, n.d.(b)). Per InvestorWords.com (n.d.), the grant price is defined as:

The price at which shares of a stock under a stock option plan may be acquired upon the exercise of stock options.

Most commonly, the option price will be the fair value or market value of the attached share at the grant date (Casson, n.d.; Milovanovic *et al.*, 2011; Ownership Solutions, n.d.; Anon, n.d.(a)). The option price for options linked to newly issued shares will be the par value of the new shares (Milovanovic *et al.*, 2011).

However, the employer has the discretion to offer the employee an option price that is lower than market value (Stafford, 2005:54). Should this occur, there will be taxation implications for the employee, which will be discussed in Chapter 4.

3 The four main types of share incentive schemes

Since the creation of the first share incentive scheme, employers have striven to develop new and more effective schemes to combat changes in taxation legislation, to remain competitive in the market with regard to remuneration, as well as to retain the best employees possible (Sacho, 2003:30; Mazibuko & Boshoff, 2003:33). Based on the literature review set out in Chapter 2, four share incentive schemes were identified as most commonly found in South Africa. In order to illustrate the progression of share incentive schemes, these four share incentive schemes are discussed in detail below.

3.1 Share option scheme

The share option scheme, the first of its kind, is fairly simple and straightforward in its functioning. The employer allocates a certain number of shares to be offered to a select group of employees via options. The option gives the employee the right to acquire a fixed number of shares at a predetermined price, namely an option price, at a fixed future date (Casson, n.d.). The option price is usually determined with reference to the fair market value on the date on which the option is granted to the employee (Milovanovic *et al.*, 2011; Ownership Solutions, 2012). However, it should be noted that an employer may choose to offer the shares at a price lower than market value, in which case the option price would be the price determined by the employer.

Once the option has been granted, the employee has a fixed period in which to exercise the option. The decision to exercise the option is completely that of the employee and may be exercised at any time within the predetermined period. The employee is not under any

obligation to accept the offer to exercise the option; however, should the offer be accepted, the employee must make full payment upon acceptance (Butler, 2005:15).

In such a share incentive scheme, full ownership of the shares will not pass to the employee until the option is exercised and full payment for the shares has been received by the employer. Therefore, no benefits, such as voting rights or dividends, attached to the shares will accrue to the employee until such future date (Butler, 2005:15).

3.2 *Share purchase scheme*

The share purchase scheme is designed to function solely through the use of a share trust set up by the employer. The share trust will hold shares for the benefit of the employees and the value of such shares will be matched by a loan granted to the share trust by the employer. Such a loan will be used to finance the acquisition of the shares (Milovanovic *et al.*, 2011; Nyelisani, 2010:21).

As is the case with the share option scheme, the employees are granted the right to purchase a set number of shares from the share trust. However, as opposed to the share option scheme, employees will purchase the shares from the trust outright by way of a loan granted to the employee by the share trust. Therefore, the employee will have a loan valued at the price of the shares being acquired from the share trust. Such loans are usually granted at market-related interest rates and payment terms (Butler, 2005:13). However, should the share trust grant the employee a loan at no interest or at lower than market-related interest, the employee will be deemed to have received a fringe benefit from the share trust, which will be taxable in terms of the Seventh Schedule to the Act. The loan to the share trust from the employer will be matched by the loans granted by the share trust to the employees. In this way, the share trust acts as a conduit from the employer to the participating employees.

In the case of the share purchase, scheme ownership of the shares will pass immediately at the share issue date, which is also the purchase date. Therefore, all benefits associated with the shares will transfer to the employee on the same date. Any dividends paid on the shares will be allocated by the share trust or employer to be used first for the payment of

any liability relating to employees' tax on the loan and then secondly for the repayment of the outstanding loan balance (Butler, 2005:13).

By including a share trust, the employer could grant financial assistance to the share trust to purchase its own shares as this type of financial assistance was not prohibited by section 38 of the old Companies Act (Republic of South Africa, 1973). In so doing, the company was able to make a loan to its executives via the conduit established in the share trust through matching loans. This was an innovative approach in legally circumventing the provisions of the old section 38. However, with the introduction of the new Companies Act No. 71 of 2008, the prohibition on financial assistance provided by the employer was lifted where share incentive schemes were involved due to the inclusion of section 97. Section 97 allows the employer to provide financial assistance to employees for the purchase of its own shares. This financial assistance is now also permitted for directors, which was previously disallowed by section 226 of the now repealed Companies Act No. 61 of 1973. However, it should be noted that financial assistance provided by the employer for the purchase of its own shares is only permitted if the share incentive scheme falls within the definition of an employee share scheme per section 95(1)(c) of the new Companies Act (refer to part 2.2 above for the definition).

3.3 *Deferred delivery share scheme*

Under the terms of this scheme, selected employees are given the same rights to purchase shares as are given under the share option scheme and the share purchase scheme (Nyelisani, 2010:21). The employer, or share trust, will grant employees the option to acquire a number of shares at a fixed price on a specified date in the future through the use of a contract (Butler, 2005:16).

However, in this case, the employees exercise the option at the grant date, but make payments over increments of time (Du Plessis, 2005:105; Butler, 2005:16; Lewis, 2011a). As the employees are given the opportunity to pay for the shares over an extended period, there is usually no need to grant a loan to the employee. Therefore, this scheme will be predominantly cash settled. The delay in payment, as well as the absence of a loan from the employer or share trust, is the primary difference between the deferred delivery share scheme and the share purchase scheme. Although the payment term of the scheme is

deferred over a period of time, the employee will be forced to exercise the option within a short period before the option lapses or expires (Butler, 2005:16).

Although the employees exercise their options immediately, ownership will only pass upon full payment of the shares' purchase price. Therefore, the employees will only take ownership of the shares at a much later date once full payment has been received by the employer or share trust. During the interim period, no dividends, voting rights or other benefits associated with the shares will accrue to the employees (Butler, 2005:16).

3.4 *Phantom share scheme*

The phantom share scheme is unique to the other three schemes discussed above due to two particular characteristics. Firstly, in this scheme, no physical shares are issued to the employee. This is beneficial to the employer and existing shareholders in that the issued share capital of the employer is not diluted (Icely *et al.*, n.d.; Ownership Solutions, 2012). The employer, or share trust, grants the employee the option to take up units (phantom shares) and therefore, the phantom share scheme is not a true share incentive scheme (Milovanovic *et al.*, 2011).

The phantom share scheme is based on the performance of the company or that of the employee (Stafford, 2005:59). A predetermined performance indicator is put in place to measure the performance of the employees and based on this measure the employee will be allotted a certain number of units or a larger bonus. Such units are often granted as a substitute to a cash bonus (Younis & Co., 2012). This is the second characteristic that makes the phantom share scheme unique in that employees are given the choice between taking their annual bonus in cash and exchanging the value of that cash bonus into units through the phantom share scheme. Should the employee then choose to participate in the scheme, a contract will be signed between the employer or share trust and the employee whereby the employee will be granted units in the scheme amounting to the equivalent of their annual cash bonus (Butler, 2005:18). In some cases, companies may choose to 'pay' the actual bonus to the employee, who in turn exchanges the bonus for the phantom shares. It is becoming more common for employers to require their employees to allocate a portion of their bonuses to the acquisition of phantom shares (Harraway, n.d.).

The units in the phantom share scheme often have two rights attached to it, namely the right to receive dividends and the right to participate in the appreciation or growth of the company (share appreciation rights) (Milovanovic *et al.*, 2011). In this way, the employees will have a more vested interest to act in the best interests of the company, as they will directly benefit from the success of the company. This aspect has made the phantom share scheme very popular in practice (Anon, n.d.(a)).

In such schemes, the employee will not hold the unit indefinitely as would be the case with an actual share. The unit usually expires after a period of time and at this point the employee will be paid out the market value of the share upon which the value of the unit is based, along with the proportion of appreciation or growth the company has experienced since the unit has been in issue (Milovanovic *et al.*, 2011).

The phantom share scheme has a rolling effect in that new units may be issued to employees each year based on their personal or the company's performance. Therefore, as certain units age and expire, new units are issued in their place. This characteristic gives this scheme an indefinite life cycle should the employer choose to keep the scheme implemented.

4 Conclusion

Share incentive schemes have evolved and developed over the years and this is largely due to changes to taxation legislation created to combat the lucrative benefits that employees were enjoying through such schemes. Chapter 4 will set out the legislation governing share incentive schemes, past and present, showing how the law has been transformed to close 'loopholes' exploited by employers. The tax implications of each of the four selected share incentive schemes will be analysed in order to determine which of the four selected schemes is most tax efficient for employees in terms of current tax legislation.

CHAPTER 4: TAX EFFICIENCY

1	Introduction	45
2	The primary tax legislation governing share incentive schemes: Section 8C	45
3	The Fourth Schedule and its impact on share incentive schemes	50
4	Seventh Schedule benefits granted in share incentive schemes	51
5	Dividends from share incentive schemes and their potential exemption	52
6	The impact of donations tax on share incentive schemes	55
7	Share incentive schemes and capital gains tax.....	56
8	Tax implications for each share incentive scheme	58
8.1	Share option scheme.....	59
8.1.1	Case study	59
8.1.2	Tax implications	60
8.2	Share purchase scheme.....	62
8.2.1	Case study	62
8.2.2	Tax implications	63
8.3	Deferred delivery share scheme.....	66
8.3.1	Case study	66
8.3.2	Tax implications	67
8.4	Phantom share scheme.....	70
8.4.1	Case study	70
8.4.2	Tax implications	71
9	Tax efficiency comparison and conclusion	73

LIST OF FIGURES

Figure 4.1:	Timeline of the share option scheme case study.....	60
Figure 4.2:	Timeline of the share purchase scheme case study	63
Figure 4.3:	Timeline of the deferred delivery share scheme case study	67
Figure 4.4:	Timeline of the phantom share scheme case study.....	71

CHAPTER 4: TAX EFFICIENCY

1 Introduction

The tax benefits attached to share incentive schemes have made such schemes attractive as a form of remuneration for employees. Although the tax benefits for employees have been limited by the SARS over the last several decades, share incentive schemes have remained a staple in the remuneration packages of employees in South Africa. The SARS has continued its campaign in limiting the tax benefits previously enjoyed by employees through the introduction of section 8A in 1969, and the subsequent introduction and continued amendment of section 8C (Blair, 2012).

This chapter will set out the taxation legislation applicable to share incentive schemes established on or after 26 October 2004. Based on the following sections of the Act, the tax implications of each of the selected schemes will be determined in relation to the employee:

- Normal income tax
- Donations tax (sections 54 to 64)
- Employees' tax (Fourth Schedule)
- Fringe benefits (Seventh Schedule)
- Capital gains tax (Eighth Schedule)

A comparison of the tax implications of each share incentive scheme will be performed, along with an analysis of the advantages and disadvantages of each scheme, in order to determine which of the selected schemes is most tax efficient for the employee.

2 The primary tax legislation governing share incentive schemes: Section 8C

Section 8C introduced several new concepts to the taxation of share incentive schemes in relation to employees, such as vesting; equity instruments; restricted versus non-restricted equity instruments; and the inclusion of a gain or loss in the employee's income rather than gross income. The granting of the right to participate in the employer's share incentive scheme will result in the value of the equity instrument being included in the employee's gross income in terms of paragraph (c) of the gross income definition in section 1 of the

Act. Paragraph (c) of the gross income definition states that any amount received or accrued to an employee in respect of services rendered or by virtue of any employment will be gross income in the hands of such an employee (Republic of South Africa, 1962). The employee's participation in the employer's share incentive scheme will fall within the ambit of the paragraph resulting in the inclusion of the value of the equity instrument in the employee's gross income. However, section 10(1)(nD) exempts any amount in relation to the equity instrument from tax until such an equity instrument has vested. The result being that any amount relating to the equity instrument in a share incentive scheme will remain untaxed until the equity instrument has vested in terms of section 8C. Section 8C(1)(a) of the Act states that the employee must include in or deduct from his or her income, any gain or loss amounting from the vesting of any equity instrument acquired by an employee by virtue of his or her employment, provided that such equity instruments were acquired by the employee on or after 26 October 2004 (De Koker *et al.*, 2011). By inserting this section into the Act, the SARS delayed the inclusion of the gain in the employee's income until all restrictions on the equity instrument have been lifted and vesting occurs. Section 8C(3) sets out the circumstances under which an equity instrument is deemed to vest in the employee. In the case of an unrestricted equity instrument, vesting will occur upon acquisition, whereas a restricted equity instrument will vest once all restrictions placed upon the equity instrument has been lifted and cease to exist. Chapter 2 part 4.3.2 sets out the various circumstances in which restricted equity instruments are deemed to vest.

The gain taxable under section 8A was to be included in the employee's gross income in terms of paragraph (i) of the gross income definition included in section 1 of the Act. However, the gross income definition makes no provision for the inclusion of any section 8C gain in the gross income of the employee (Stafford, 2005:38). Based on the wording of section 8C, the gain will be included in the employee's income, which is defined in section 1 as follows:

"Income" means the amount remaining of the gross income of any person for any year or period of assessment after deducting there from any amounts exempt from normal tax under Part I of Chapter II;

A notable change made by section 8C was the benefit granted to the employee in the form of a deduction from income of any loss incurred under section 8C. Under section 8C, it is

possible for an employee to incur a loss via the vesting of an equity instrument when the market value of the said equity instrument is lower than the grant or strike price. However, many share incentive schemes are set up with a 'stop-loss' provision written into the scheme rules in order to prevent the employee from suffering losses due to the share incentive scheme. Under such a provision, the employee is given a 'put option' (a put option gives the employee the right, but not the obligation, to sell a specified number of the underlying equity instruments back to the employer at a predetermined fixed price within a predetermined period of time (Hansen, 2006)) to sell the equity instrument back to the share trust or employer at the grant or strike price at a specified date when the strike price of the equity instrument exceeds market value (Solomon & Muller, 2010). As the employee will dispose of the equity instruments to the share trust at a value exceeding market value, the transaction will be deemed to be a non-arm's length transaction and will fall into the scope of section 8C(5)(a). Per section 8C(3)(b)(ii), an equity instrument acquired by an employee is deemed to vest immediately before the employee disposes of the restricted equity instrument, unless such disposal is contemplated in section 8C(4) or 8C(5)(a), (b) or (c) (provided that such occurs earlier than the other circumstances contemplated by section 8C(3)(b)) (Republic of South Africa, 1962). Based on section 8C(3)(b)(ii), the equity instruments will not vest in the employee upon disposal of such equity instruments to the share trust. As all restrictions relating to the equity instruments will cease to exist in relation to the employee, the equity instruments will vest in the share trust upon acquisition. The share trust will suffer a loss as the strike price paid by the trust will exceed the current market value. However, per section 8C(5)(a), the loss will be deducted from the employee's income (Solomon *et al.*, 2010).

As was the case with section 8A, section 8C will only apply to share incentive schemes where the employee acquires the equity instrument due to his or her employment. However, section 8C goes further than section 8A by including in its scope equity instruments acquired from the employer, associated institution in relation to said employer, or any other person employed by the employer or above-mentioned associated institution (Republic of South Africa, 1962). Section 8C goes further by including definitions for 'employer' and 'associated institution', which refer to the same definitions included in paragraph 1 of the Seventh Schedule.

By the inclusion of the aforementioned terms, as well as the wider net cast by section 8C(1)(a), section 8C effectively includes transactions that may previously have been excluded by section 8A. Such transactions include schemes that use share trusts to administer the transactions with employees rather than acquisitions directly from the employer. In order for the gains realised by an employee participating in a share incentive scheme to be included in the scope of section 8C, a causal link needs to be established between the equity instruments held by the employee and the employee's employment. The term 'employer' is defined in paragraph 1 of the Seventh Schedule (Republic of South Africa, 1962), as follows:

"employer" means any person who is an employer as defined in paragraph 1 of the Fourth Schedule and includes--

a) any company; and

b) for the purpose of paragraph 2 and the determination of the cash equivalent of the value of any taxable benefit granted to any person who derives remuneration as defined in the said paragraph from employment in the public service or any administration or undertaking of the State or who holds office under the Republic, the State.

Based on the definition above, an employer is further defined in paragraph 1 of the Fourth Schedule (Republic of South Africa, 1962). Through the linkage of definitions, section 8C seeks to include every possible meaning of the term employer. The definition of 'employer' per the Fourth Schedule is as follows:

"employer" means any person (excluding any person not acting as a principal, but including any person acting in a fiduciary capacity or in his capacity as a trustee in an insolvent estate, an executor or an administrator of a benefit fund, pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or any other fund) who pays or is liable to pay to any person any amount by way of remuneration, and any person responsible for the payment of any amount by way of remuneration to any person under the provisions of any law or out of public funds (including the funds of any provincial council or any administration or undertaking of the State) or out of funds voted by Parliament or a provincial council.

It is clear from the definitions above, that a share trust cannot be said to be an employer in the classic meaning of the term as it is not liable to pay the employee's remuneration under the provisions of any law of the State. Per section 1 of the Act, a trust is defined as any trust fund consisting of cash or other assets that are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person (Republic of South Africa, 1962). A share trust in a share incentive scheme will be a trust as defined in section 1 of the Act as the trustee will have the fiduciary duty to act on behalf of the employer in administering the share incentive scheme for the benefit of the employees. The trustee will have been appointed under a trust deed that will govern the administration of the share trust. Paragraph 1 of the Seventh Schedule to the Act (Republic of South Africa, 1962) defines an 'associated institution' as follows:

"associated institution", in relation to any single employer, means--

- a) where the employer is a company, any other company which is associated with the employer company by reason of the fact that both companies are managed or controlled directly or indirectly by substantially the same persons;*
- or*
- b) where the employer is not a company, any company which is managed or controlled directly or indirectly by the employer or by any partnership of which the employer is a member; or*
- c) any fund established solely or mainly for providing benefits for employees or former employees of the employer or for employees or former employees of the employer and any company which is in terms of paragraph (a) or (b) an associated institution in relation to the employer, but excluding any fund established by a trade union or industrial council and any fund established for postgraduate research otherwise than out of moneys provided by the employer or by any associated institution in relation to the employer;*

A share trust designed with the sole purpose of administering the share incentive scheme on behalf of the employer, for the benefit of the employees, will fall within the scope of subparagraph (c) of the definition above and therefore would be an associated institution in relation to the employer. Therefore, any equity instrument granted to the employee by a share trust in relation to the employer will fall within the scope of section 8C upon its vesting due to the causal link to employment.

3 The Fourth Schedule and its impact on share incentive schemes

The gain to be included in the income of the employee in terms of section 8C will be governed by the Fourth Schedule of the Act, and will be subject to employees' tax (Van Eeden, 2011). Per subparagraph (e) of the 'remuneration' definition included in paragraph 1 of the Fourth Schedule, any gain determined in terms of section 8C will be included in the remuneration of the employee (Republic of South Africa, 1962).

Paragraph 11A sets out specific rules for how gains, made as a result of the vesting of an equity instrument per section 8C, should be treated by employers in respect of employees' tax. Per subparagraph (2), employees' tax must be deducted from the employee's remuneration by the person from whom the employee acquired the equity instrument (further "the person"), in the year of assessment in which the equity instrument vests. In scenarios where such a person is an associated institution and is unable to deduct the full amount of employees' tax, as the tax payable exceeds the gain to which it relates, the person and the employer will be jointly and severally liable for the full payment of the employees' tax (Republic of South Africa, 1962).

It is customary in practice for employers to deduct employees' tax on the gain per section 8C at the maximum marginal tax rate applicable to the employee (Croome & Kretzmann, 2011). This is consistent with the method used by employers to calculate any other form of employees' tax on a monthly basis (Croome *et al.*, 2011). However, prior to the deduction of the employees' tax applicable to section 8C gains, the person or the employer must ascertain the amount to be deducted with the Commissioner of the SARS, as provided by paragraph 11A(4) of the Fourth Schedule (Republic of South Africa, 1962). Failure by the employer to obtain such a directive from the Commissioner may lead to penalties being imposed by the SARS against the employer in terms of section 75B (Croome *et al.*, 2011).

Paragraph 11A(6) places an onus on the employee to notify the person or the employer of any gains made from the vesting of equity instruments where neither the person nor the employer were a party to the transaction. Should the employee fail to do so, without just cause, he or she will be guilty of an offence and liable on conviction to a fine not exceeding R2,000 as provided by paragraph 11A(7) (Republic of South Africa, 1962).

4 Seventh Schedule benefits granted in share incentive schemes

Subparagraph (b) of the 'remuneration' definition included in paragraph 1 of the Fourth Schedule makes provision for the inclusion of any amount to be included in the employee's gross income in terms of paragraph (i) of the 'gross income' definition in section 1 of the Act (Republic of South Africa, 1962). Paragraph (i) of the 'gross income' definition states that the following will be included in the employee's gross income:

the cash equivalent, as determined under the provisions of the Seventh Schedule, of the value during the year of assessment of any benefit or advantage granted in respect of employment or to the holder of any office, being a taxable benefit as defined in the said Schedule, and any amount required to be included in the taxpayer's income under section 8A.

Per paragraph 2 of the Seventh Schedule, there are two scenarios where a taxable benefit could be included in the employee's gross income due to such employee's participation in a share incentive scheme. The first is where the employer grants the employee an asset for no consideration or for consideration that is less than the value of such asset. For the purposes of the subparagraph (a) of paragraph 2, an asset may consist of any goods, commodity, financial instrument or property of any nature (other than money) (Republic of South Africa, 1962). Consideration, for the purpose of the Seventh Schedule, is defined as any consideration given by an employee that does not include consideration in the form of services rendered or to be rendered by said employee (Republic of South Africa, 1962). Although paragraph 2(a) could be applied to an employee participating in a share incentive scheme, where the employer grants the employee a financial instrument for less than market value, subparagraph (dd) of paragraph 2(a) specifically excludes any equity instruments contemplated in section 8C from the scope of paragraph 2(a) (Republic of South Africa, 1962).

The second scenario relates to paragraph 2(f) where an employer grants a loan to an employee, where no interest is payable or where the interest rate payable is lower than the official rate of interest (Republic of South Africa, 1962). This scenario is especially prevalent in share purchase schemes, as discussed in Chapter 3. The loan may be granted by either the employer or via a share trust. In the case of a share trust, the trust

will be an associated institution as defined in paragraph 1 of the Seventh Schedule, as well as the Fourth Schedule (refer to part 3 above). Per paragraph (4) of the Seventh Schedule, any benefit or advantage granted to the employee by an associated institution in relation to the employer will be deemed to be a taxable benefit granted to the employee by the employer. As such, the related cash equivalent will be determined as if the employer granted the benefit and will be included in the gross income of the employee as per paragraph (i) of the gross income definition (Republic of South Africa, 1962).

The guidelines for the determination of the cash equivalent to be included under paragraph 2(f) are set out in paragraph 11 of the Seventh Schedule. Such cash equivalent will be the interest payable on the loan using the official interest rate less the amount of interest actually incurred by the employee on such loan (Republic of South Africa, 1962). The official interest rate, for the purposes of the Seventh Schedule, will be the South African repurchase rate plus 100 basis points. This rate of interest will only be applicable to loans granted in the South African currency (Republic of South Africa, 1962). Paragraph 11(e) grants the employee some tax relief in that any amount included the employee's taxable income, as a result of being a cash equivalent determined by paragraph 11, will be deductible under section 11(a). However, the deduction provided by section 11(a) will only be allowed in cases where the loan is utilised by the employee in the production of income. Such an amount will be deemed to be interest actually incurred by the employee in the production of income (Republic of South Africa, 1962). Additionally, if the loan to the employee by the employer is less than R3,000 at any relevant time and was granted by the employer as a casual loan, there will be no value included as a cash equivalent for the employee as per paragraph 11(d) (Republic of South Africa, 1962).

5 Dividends from share incentive schemes and their potential exemption

Prior to 2011, employees participating in share incentive schemes enjoyed the tax benefit of receiving exempt dividends from such schemes. Certain share incentive schemes took advantage of this tax benefit by structuring the scheme in such a way that the employee received tax-free dividends without any other participation rights. An example of such a scheme is the phantom share scheme, where employees are granted a phantom share or unit that is linked to the value of the employer's equity share capital. In such a scheme, the employees will be entitled to dividends as if they held actual equity shares. The employees

may be entitled to participation in the growth or appreciation of the employer, but they do not hold actual equity shares. This type of share incentive scheme has the effect of converting the employee's salary into dividends through the scheme. In so doing, the potential tax liability of the employee was reduced as the dividends received were exempt (Republic of South Africa, 2012a:15).

The Taxation Laws Amendment Act of 2010 put an end to this benefit through the introduction of subsection (dd) to the dividend exemption included in section 10(1)(k)(i) (Republic of South Africa, 2010b:44). Subsection (dd) stated that any dividend in respect of a restricted equity instrument as defined by section 8C would no longer be exempt from tax, unless such restricted equity instrument constituted an equity share or the dividend itself constituted an equity instrument as defined in section 8C (Republic of South Africa, 2010b:44). This amendment to the Act was made effective as from 1 January 2011 (Spamer *et al.*, 2010). Along with the introduction of section 10(1)(k)(i)(dd), the definition of an 'equity share' was amended in section 1 of the Act:

equity share means, in relation to any company, any share or similar interest in that company, excluding any share or similar interest that does not carry any right to participate beyond a specified amount in a distribution.

The importance of this definition is that any equity instrument that does not carry the right to participate in a distribution beyond a specified amount will not be deemed to be an equity share for the purposes of section 10(1)(k)(i)(dd), and the dividends thereof will not be exempt from tax. Based on the definition above, a preference share will not be an equity share and any dividends received by the employee from a preference share as part of a share incentive scheme will no longer be exempt (Lewis, 2011c). Also to be considered, is the impact of the above definition on phantom shares. As a phantom share or unit only has the right to participate in dividends and or the right to participate in the appreciation value of the employer over time, the phantom share or unit is limited in its ability to participate in a distribution beyond a specified amount. A phantom share or unit cannot be said to be an equity share for the purposes of section 10(1)(k)(i)(dd) and any dividends from such a share or unit will no longer be exempt (Brincker, 2011).

The introduction of this limitation on the exempt of dividends received by employees in terms of share incentive schemes was perceived in practice as being unnecessarily harsh. Spamer and Burger point out that the employee would not only be taxed on the underlying gains of his or her investment, but also the fruits of that investment (Spamer *et al.*, 2010). The additional tax to be paid by employees due to the inclusion of the share incentive scheme dividends in his or her income will also negatively affect the ability of the employee to fully settle his or her debt to funding institutions where such dividends were ceded to institutions to settle debt (Spamer *et al.*, 2010).

The Taxation Laws Amendment Act of 2011 amended the definition of an 'equity share' and added in the definition of 'share'. The amended definition of an 'equity share' and the new definition of a 'share' are as follows:

'equity share' means any share or similar interest in a company, excluding any share or similar interest that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution.

'share' means, in relation to any company, any share or similar equity interest in that company.

The intention of the SARS for the introduction of the new definition of the word 'share' was to clarify that the word 'share' includes similar equity interests (Louw, 2012).

The Taxation Laws Amendment Act of 2011 also sought to narrow the overly broad net cast by the amendment to section 10(1)(k)(i) in 2010. As per the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011, it was never the intention of the amendment to tax dividends received by employees on equity shares held by share trusts on their behalf (Republic of South Africa, 2012a:15). The amended section 10(1)(k)(i)(dd) includes a carve-out provision whereby any dividend received in respect of a restricted equity instrument as defined in section 8C will be exempt from tax if such restricted equity instrument constitutes an interest in a trust that holds only equity shares (Republic of South Africa, 2012b:74). This amendment allows employees and share trusts the exemption, while still retaining the anti-avoidance provisions originally envisioned by

section 10(1)(k)(i)(dd) (Republic of South Africa, 2012a:15). The amendment is retrospectively effective as from 1 January 2011 (Lewis, 2011c).

6 The impact of donations tax on share incentive schemes

For the purposes of the taxation of employees participating in share incentive schemes, there may be certain scenarios in which donations tax may be applicable. One such scenario is where an employee sells a restricted equity instrument in a non-arm's length transaction or to a connected person, as contemplated in section 8C(5)(a). Similarly, if another person acquires the restricted equity instrument by virtue of the employee's employment, the restricted equity instrument is deemed to have been acquired by the employee and disposed of by the employee to such other person in a manner contemplated in section 8C(5)(b) (Republic of South Africa, 1962). In such scenarios, section 58(2) of the Act stipulates that the employee will be deemed to have donated the restricted equity instrument to such other person at the time that the restricted equity instrument vests, as contemplated in section 8C (Republic of South Africa, 1962). The value to be taxed in the hands of the employee for the purposes of donations tax will be the fair market value of the restricted equity instrument at the time of vesting, less any consideration given in respect of the donation (Republic of South Africa, 1962). Employees have sought ways in which to trigger taxation under section 8C at an earlier date in order to limit the growth in value of the restricted equity instruments. In so doing, the gain taxable under section 8C would be smaller, resulting in a lower tax liability for the employee. The purpose of section 58(2) is to introduce an anti-avoidance provision that would limit this artificial trigger of taxation under section 8C (Stiglingh *et al.*, 2012:804).

Section 54 of the Act levies a tax on any property donated by any resident, subject to the exemptions set out in section 56. The rate of tax to be applied for donations is 20 per cent as set out in section 64 of the Act (Republic of South Africa, 1962). In order to determine whether a disposal qualifies as a donation, the definitions of the terms 'donation' and 'property' must be analysed. Section 55(1) defines a donation as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right (Republic of South Africa, 1962). For the purposes of donations tax, as contemplated in sections 54 to 64 of the Act, property is defined as any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated (Republic of South Africa, 1962). Based on the

definition of the term 'property', it can be noted that property can include restricted equity instruments as contemplated in section 8C.

7 Share incentive schemes and capital gains tax

Share incentive schemes are governed by section 8C. In order to avoid double taxation under the Eighth Schedule, the right to acquire equity instruments is deemed to be a non-disposal for capital gains tax purposes by paragraph 11(2)(j) of the Eighth Schedule to the Act (De Koker *et al.*, 2011). Any disposal of an equity instrument contemplated in section 8C will be disregarded for capital gains tax as long as that equity instrument has not yet vested in the hands of the employee at the date of the disposal (Republic of South Africa, 1962). Upon vesting of the equity instrument, the resulting gain or loss will be included or deducted from the employee's income in terms of section 8C. Should the employee dispose of the vested equity instrument at a later date, a disposal will take place as per paragraph 11(1) of the Eighth Schedule (De Koker *et al.*, 2011). It should be noted that, for the gain on a subsequent disposal to be treated as a capital gain in terms of the Eighth Schedule to the Act, the intention of the employee must not have been to dispose of the equity instruments in the process of carrying on a business or to make a profit for income purposes. In such cases, the gain on subsequent disposal would be treated as income and not as a capital gain. The capital gain or loss to be included in the income of the employee upon the disposal of the vested equity instrument will be the difference between the proceeds upon disposal and the base cost of the equity instrument. Paragraph 20(1)(h)(i) sets the base cost of the equity instrument as the market value of such equity instrument at the vesting date (Republic of South Africa, 1962; Stiglingh *et al.*, 2012:868). The purpose of utilising the market value of the equity instrument upon vesting as the base cost of the equity instrument in terms of paragraph 20(1)(h)(i) is to prevent the double taxation effect upon disposal. Should this provision not have been made in the Eighth Schedule to the Act, the employee would have been taxed twice on the gain realised at the subsequent disposal as the difference between the market value of the equity instrument at vesting and the base cost, namely the grant price, had already been taxed in terms of section 8C.

Paragraph 12(2)(a) of the Eighth Schedule makes provision for circumstances where the employee ceases to be a resident and holds equity instruments that have not yet vested.

In such cases, the employee will not be deemed to have disposed of the equity instrument at the time at which he or she ceases to be resident in South Africa (De Koker *et al.*, 2011). The non-resident employee will include in his or her income the gain or loss resulting from the vesting of the equity instrument per section 8C at the point in time when such equity instrument vests in the employee. Section 9H of the Act provides for circumstances where the employee ceases to be resident in South Africa. The employee will be deemed to have disposed of all his or her assets immediately prior to the date upon which he or she ceases to be a resident as per section 9H(2)(a). Section 9H(2)(b) provides that the employee is deemed to have reacquired each of those assets immediately after the date of deemed disposal at an amount equal to the same market value as the disposal. However, per section 9H(3)(d), the provisions of section 9H(2) will not apply to equity instruments as contemplated in section 8C, which have not yet vested at the time that the employee ceases to be resident in South Africa. No tax event will occur until the vesting of the equity instrument contemplated in section 8C for the purposes of normal income tax or capital gains tax.

A disposal of an equity instrument by the employee to another person by way of donation or to a connected person in a non-arm's length transaction shall be treated as a disposal for capital gains tax purposes in accordance with paragraph 38(1), provided that such equity instrument has already vested in the employee at the time of disposal. Should the equity instrument be unvested at the time of disposal, there will be no disposal for the purposes of capital gain tax as per paragraph 11(2)(j) (Lewis, 2011b). Paragraph 38(1)(a) states that the employee disposing of the equity instrument will be deemed to have disposed of the equity instrument at market value at the date of disposal. Conversely, the person acquiring the equity instrument will be deemed to have acquired the equity instrument at a cost equal to the market value at the disposal date and will be treated as the cost actually incurred by the person in accordance with paragraph 20(1)(a) (Republic of South Africa, 1962).

An anti-avoidance provision is included in paragraph 39(1) of the Eighth Schedule, whereby the employee must disregard any capital loss incurred upon the disposal of an equity instrument to any person who was a connected person in relation to the employee immediately prior to the disposal. However, should the employee make a capital gain on any subsequent disposal to the same connected person, the previously disallowed capital

loss may be set off against the new capital gain as per paragraph 39(2) (Stiglingh *et al.*, 2012:897). For the purposes of paragraph 39, a connected person in relation to the employee does not include a relative that is not a parent, child, stepchild, brother, sister, grandchild or grandparent of that employee (Republic of South Africa, 1962).

It should be noted that paragraph 39(1) does not apply to the situations where a share trust disposes of an equity instrument contemplated in section 8C to the employee and such trust is an associated institution in relation to the employer as per paragraph 1 of the Seventh Schedule. However, paragraph 39(1) will apply if the disposal of the equity instrument to the employee was not by virtue of the employee's employment, office as a director or services rendered to the employer (Republic of South Africa, 1962; Stiglingh *et al.*, 2012:898).

8 Tax implications for each share incentive scheme

The tax implications of a share incentive scheme play a significant role in the objectives, design and implementation of the scheme. Although a share incentive scheme serves the dual purpose of motivating and incentivising employees, while attracting and retaining such employees, no share incentive scheme will be truly effective without being as tax efficient as possible for all the parties involved. For the purposes of this study, the tax implications of each of the selected share incentive schemes, with reference to the relevant income tax legislation, will be assessed only from the employee's point of view.

To illustrate the tax implications of each scheme, as well as for ease of comparison between the schemes, a case study will be performed and analysed for each of the selected schemes. Each case study will contain the same underlying facts, such as number of shares or units available for acquisition grant price, market values, etc. However, due to the nature of each of the selected schemes, each case study will have certain different variables. The case studies below include any legislation that could result in a different outcome for taxation purposes if applied to each of the four share incentive schemes selected. Any income tax legislation discussed in parts 2 to 7 of this chapter, having the same tax consequences across all four schemes, has been excluded from the case studies below. For the purposes of the case studies included in parts 8.1 to 8.4, any shares will form part of the employer's ordinary share capital.

8.1 Share option scheme

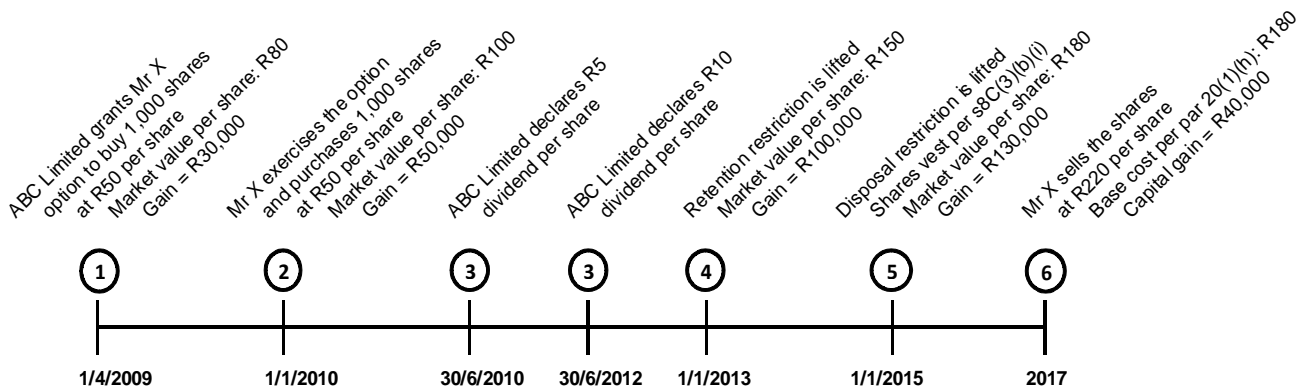
8.1.1 Case study

Mr X is an employee of ABC Limited, a South African resident company. ABC Limited grants Mr X an option to acquire 1,000 shares in ABC Limited at R50 per share on 1 April 2009. Should Mr X choose to exercise the option, he must do so within five years. The shares available for acquisition under the option will be subject to the following restrictions:

- a) Mr X remaining in the employment of ABC Limited for a period of three years after the exercise of the option; and
- b) a disposal restriction whereby Mr X will be prohibited from freely disposing of the said shares for a period of five years after the exercise date.

Mr X exercises the option and purchases 1,000 shares from ABC Limited for R50,000 on 1 January 2010. ABC Limited declares dividends amounting to R5 and R10 per share on 30 June 2010 and 30 June 2012, respectively. The retention restriction is lifted on 1 January 2013, as Mr X has remained in the employment of ABC Limited for the required period of three years. Mr X is free to dispose of his shares in 2015; however, he chooses to sell all 1,000 shares in 2017. The market value per share is as follows for each of the aforementioned dates:

- 1 April 2009: R80
- 1 January 2010: R100
- 1 January 2013: R150
- At the time the disposal restriction is lifted in 2015: R180
- At the time of disposal in 2017: R220

Figure 4.1: Timeline of the share option scheme case study

8.1.2 Tax implications

- (1) At the time the option is granted to Mr X (i.e. 1 April 2009), the value of the option will be included in Mr X's gross income in terms of paragraph (c) of the gross income definition included in section 1 to the Act. However, there will be no impact on Mr X's tax liability as section 10(1)(nD) exempts the receipt of an unvested equity instrument from tax (Republic of South Africa, 1962). An option is included in the definition of an equity instrument as per section 8C(7). The option will be a restricted equity instrument as it gives Mr X the right to acquire a share in ABC Limited, which has restrictions imposed upon it, namely the retention and disposal restrictions. Due to these restrictions being imposed upon the shares, and therefore the option, the option will be deemed to be unvested at the time it is granted to Mr X.
- (2) Upon the exercise of the option by Mr X on 1 January 2010, a gain of R50,000 is realised by Mr X (market value of R100 less the option grant price of R50). However, the gain will not be included in Mr X's income because the shares have not yet vested at the time of acquisition. The exchange of the option for the shares will not be a disposal for the purposes of section 8C and Mr X will not be taxed on the exercise of the option. The exchange of one restricted equity instrument for another restricted equity instrument is specifically excluded from the scope of section 8C by section 8C(1)(b)(i) and such an exchange will not constitute a vesting event for the purposes of section 8C.

- (3) The dividend received by Mr X on 30 June 2010 amounting to R5,000 will be exempt from tax in terms of section 10(1)(k)(i). However, per the amendments made to section 10(1)(k)(i) by the Taxation Laws Amendment Acts of 2010 and 2011, the R10,000 dividend received on 30 June 2012 will only be exempt from tax if such dividend is in respect of a restricted equity instrument that is an equity share (Republic of South Africa, 1962). As the shares acquired by Mr X under the option form part of the ordinary share capital of ABC Limited, they are equity shares as defined in section 1 of the Act and the R10,000 dividend will remain exempt from tax in terms of section 10(1)(k)(i)(dd)(A).
- (4) The retention restriction imposed by ABC Limited is lifted on 1 January 2013 and a gain of R100,000 is made by Mr X (market value of R150 less the option grant price of R50). However, as with the gain made at the exercise of the option above, the gain will not be included in the income of Mr X as it is exempted by section 10(1)(nD). Although the retention restriction has been lifted, there is still a disposal restriction in place resulting in the shares not being fully vested yet.
- (5) The disposal restriction placed on the shares by ABC Limited is lifted on 1 January 2015 and Mr X is free to dispose of the shares as he wishes. It is at this point that the shares become unrestricted and vest in Mr X as all the restrictions imposed upon the shares cease to exist (as per section 8C(3)(b)(i)). A gain of R130,000 will be included in the income of Mr X as per section 8C(2)(a)(ii) (market value of R180 less the option grant price of R50 for 1,000 shares).
- (6) Upon the sale of Mr X's shares in ABC Limited in 2017, a capital gain will be realised. The gain will be calculated as the difference between the proceeds and the market value of the shares at the vesting date, as per paragraph 20(1)(h) of the Eighth Schedule (Republic of South Africa, 1962). The capital gain of R40,000 will be included in Mr X's income in accordance with paragraph 3(a) if there are no other capital gains or losses. However, paragraph 5(1) of the Eighth Schedule provides for an annual exclusion amounting to R30,000 for a natural person (Republic of South Africa, 1962). Taking the exclusion into account, Mr X will include a capital gain of R10,000 in his taxable income at a rate of 33.3 per cent as

prescribed by paragraph 10(a) of the Eighth Schedule (R3,330 calculated as the market value of R220,000 less the base cost of R180,000 less R30,000 annual exclusion multiplied by 33.3 per cent).

The total taxable income earned by Mr X due to his participation in the share option scheme offered by ABC Limited will be R133,330, made up as follows:

(1) Granting of option to Mr X (R30,000 gain exempt per s 10(1)(nD))	R 0
(2) Exercise of option by Mr X (R50,000 gain, but no vesting takes place)	R 0
(3) Dividend received on 30 June 2010 (R5,000 exempt per s 10(1)(k)(i))	R 0
Dividend received on 30 June 2012 (R10,000 exempt per s 10(1)(k)(i)(dd)(A))	R 0
(4) Retention restriction lifted (R100,000 gain exempt per s 10(1)(nD))	R 0
(5) Disposal restriction lifted and vesting occurs (R130,000 gain per s 8C(2)(a)(ii))	R 130,000
(6) Capital gain upon disposal (R40,000 gain less R30,000 exclusion at 33.3%)	R 3,330
Total taxable income (from 2009 to 2017)	<u><u>R133,330</u></u>

8.2 Share purchase scheme

8.2.1 Case study

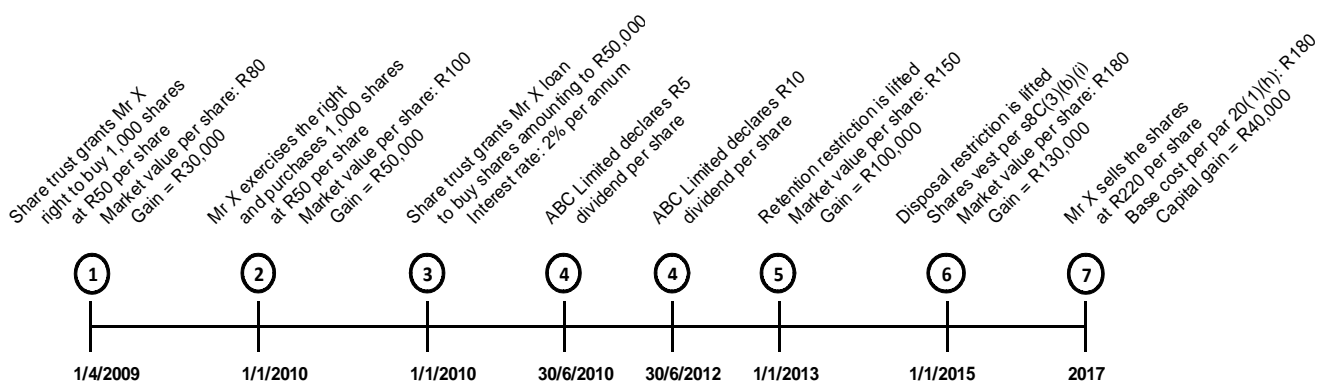
Mr X is an employee of ABC Limited, a South African resident company. ABC Limited establishes a share trust with the sole purpose to oversee and manage the administration of ABC Limited's share incentive scheme. ABC Limited transfers 100,000 shares to the share trust and grants a loan to the share trust to finance the acquisition of the shares. In so doing, the value of the shares held by the share trust is matched by the loan granted by ABC Limited, amounting to R800,000.

The share trust grants Mr X the right to acquire 1,000 shares in ABC Limited at R50 per share on 1 April 2009. The right to acquire the shares, as well as the shares themselves, will be subject to the same terms and restrictions as per the case study in part 8.1 above. Mr X exercises his right to purchase 1,000 shares from the share trust on 1 January 2010, and the share trust grants Mr X a loan for the R50,000 at an interest rate of 2 per cent. The official interest rates, for the purposes of the Act and as published by the SARS (2012:2), are as follows:

- 1 September 2009 to 30 September 2010: 8 per cent
- 1 October 2010 to 28 February 2011: 7 per cent
- 1 March 2011 to 31 July 2012: 6.5 per cent
- 1 August 2012 until a change in the Repo rate is made: 6 per cent

Per the conditions of the loan, any dividends received by Mr X during the loan's term will be applied as payment of the interest on the loan. Ownership of the shares will transfer to Mr X on 1 January 2010. Full payment of the loan from the share trust is made on 31 December 2013. Further the case study is the same as that included in part 8.1 above.

Figure 4.2: Timeline of the share purchase scheme case study



8.2.2 Tax implications

- (1) Mr X is granted the right to acquire shares in ABC Limited by its share trust. In order for section 8C to apply to the share purchase plan in question, Mr X had to have been granted the right to the shares by virtue of his employment at ABC Limited. As the right to acquire shares was granted to Mr X by the share trust, it must be determined whether the share trust falls within the definition of an employer for the purposes of section 8C. Section 8C defines the term ‘employer’ as the definition included in paragraph 1 of the Seventh Schedule, which similarly refers to paragraph 1 of the Fourth Schedule. The definition of ‘employer’ in paragraph 1 of the Fourth Schedule to the Act includes the administrator of any fund (Republic of South Africa, 1962). The share trust established by ABC Limited to administer the share purchase plan will fall within this definition. Based on this definition, it can be

established that, although the share trust granted the right to Mr X, the right was granted by virtue of Mr X's employment at ABC Limited.

As was the case with the share option scheme, no gain will be included in the taxable income of Mr X upon his receipt of the right to acquire shares in ABC Limited. The right acquired by Mr X from the share trust will be an equity instrument per subsection (b) of the equity instrument definition included in section 8C(7). The right will be a restricted equity instrument, like the option in part 8.1, as the right will be subject to the same restrictions imposed upon the share to which it will convert should the right be exercised. The value of the right will be included in the gross income of the employee in terms of paragraph (c) of the gross income definition included in section 1 of the Act. However, the right will be unvested on 1 April 2009 and the value of the right will be exempt from tax in terms of section 10(1)(nD).

- (2) A gain of R50,000 is made by Mr X on 1 January 2010 when he exercises his right to acquire the 1,000 shares from the share trust. As was the case with the share option scheme, the gain will be included in his gross income per paragraph (c) of the gross income definition and will be exempted from tax in terms of section 10(1)(nD) as the restricted equity instrument has not yet vested (Republic of South Africa, 1962).
- (3) Mr X is granted a loan by the share trust that carries an interest rate that is less than the official interest rate, as defined in paragraph 1 of the Seventh Schedule. Per paragraph 2(f) of the Seventh Schedule, Mr X will be required to include the cash equivalent of this tax benefit in his gross income for each year that he enjoys this benefit. The cash equivalent, as determined by paragraph 11(a) of the Seventh Schedule, will be the amount of interest that Mr X would have incurred on the loan at the official interest rate, less the amount of interest actually incurred (Republic of South Africa, 1962; South African Revenue Service, 2012). The total cash equivalent amounting to R9,311 for Mr X will be calculated as follows:
- 1 January 2010 to 30 September 2010: cash equivalent = R2,250
 - Interest at the official interest rate: $R50,000 \times 8\% \times 9/12 = R3,000$
 - Interest actually incurred: $R50,000 \times 2\% \times 9/12 = R750$
 - 1 October 2010 to 28 February 2011: cash equivalent = R1,041

- Interest at the official interest rate: $R50,000 \times 7\% \times 5/12 = R1,458$
- Interest actually incurred: $R50,000 \times 2\% \times 5/12 = R417$
- 1 March 2011 to 31 July 2012: cash equivalent = R3,187
 - Interest at the official interest rate: $R50,000 \times 6.5\% \times 17/12 = R4,604$
 - Interest actually incurred: $R50,000 \times 2\% \times 17/12 = R1,417$
- 1 August 2012 to 31 December 2013: cash equivalent = R2,833
 - Interest at the official interest rate: $R50,000 \times 6\% \times 17/12 = R4,250$
 - Interest actually incurred: $R50,000 \times 2\% \times 17/12 = R1,417$

It should be noted that if the share trust had lent the R50,000 to Mr X at the official interest rate, no taxable benefit would exist, and Mr X would not be required to include the cash equivalent of R9,311 in his gross income.

- (4) Although Mr X has not made full payment on the loan from the share trust at the dates of the dividend payments, he will still be entitled to receive the dividends as ownership of the shares transferred to him on 1 January 2010. The treatment of the dividends received under the share purchase scheme will be the same as those received by Mr X under the share option scheme, as contemplated in part 8.1 above. As long as the dividends received relate to restricted equity instruments that constitute equity shares, as is the case for Mr X, such dividends will be exempt from tax per section 10(1)(k)(i) (prior to 1 January 2011) and the amended section 10(1)(k)(i)(dd)(A) as from 1 January 2011.
- (5) The gain made by Mr X (R100,000) on the day when the retention restriction is lifted will not be taxable in terms of section 8C, as the disposal restriction placed on the shares has not yet lifted, and vesting has not yet occurred.
- (6) As with the share option scheme in part 8.1, Mr X will include a gain of R130,000 in his income in 2015 when the disposal restriction is lifted. The gain will be included immediately after all restrictions placed upon the shares are lifted, namely 1 January 2015, as per section 8C(3)(b)(i). Similarly, no capital gain will be made by Mr X as the gain of R130,000 will already have been included in his taxable income during 2015 per section 8C(2)(a)(ii).

- (7) Mr X will make a capital gain of R40,000 in 2017, calculated as the proceeds upon disposal (R220 per share = R220,000) less the base cost of the shares (R180 per share = R180,000), as determined by paragraph 20(1)(h). As was the case with the share option scheme in part 8.1, the annual exclusion per paragraph 5(1) amounting to R30,000 will reduce the capital gain of R40,000 resulting in a capital gain of R10,000 being included at 33.3 per cent in Mr X's taxable income (per the assumption that there are no other capital gains/(losses)).

The total taxable income earned by Mr X due to his participation in the share purchase scheme offered by ABC Limited will be R142,641, made up as follows:

(1) Granting of right to Mr X (R30,000 gain exempt per s 10(1)(nD))	R 0
(2) Exercise of right by Mr X (R50,000 gain, no vesting has taken place)	R 0
(3) Cash equivalent of the taxable benefit from the low-interest loan (per par 11(a))	R 9,311
(4) Dividend received on 30 June 2010 (R5,000 exempt per s 10(1)(k)(i))	R 0
Dividend received on 30 June 2012 (R10,000 exempt per s 10(1)(k)(i)(dd)(A))	R 0
(5) Retention restriction lifted (R100,000 gain, no vesting has taken place)	R 0
(6) Disposal restriction lifted and vesting occurs (R130,000 gain per s 8C(2)(a)(ii))	R 130,000
(7) Capital gain upon disposal (R40,000 gain less R30,000 exclusion at 33.3%)	R 3,330
Total taxable income (from 2009 to 2017)	<u>R142,641</u>

8.3 Deferred delivery share scheme

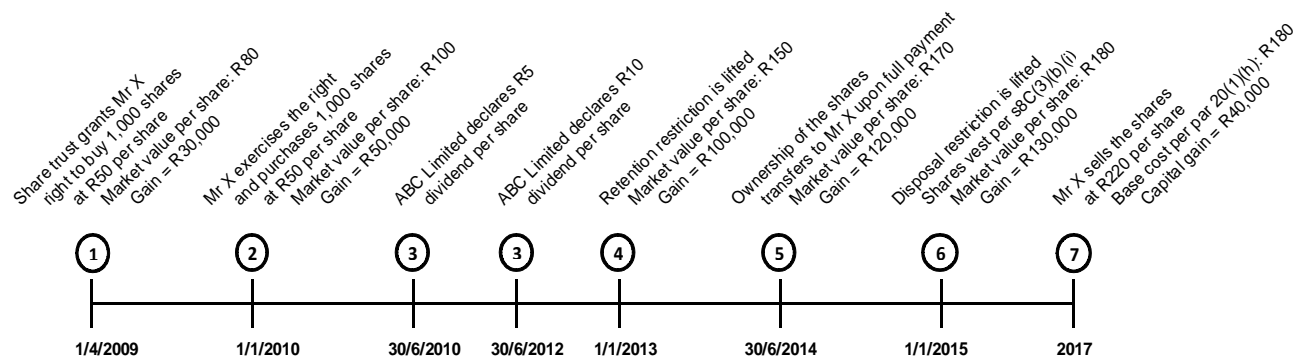
8.3.1 Case study

As per the case study in part 8.2 above, Mr X is an employee of ABC Limited, a South African resident company with a share trust that administers its share incentive scheme.

Mr X is granted the right to acquire 1,000 shares in ABC Limited at R50 per share under a contract on 1 April 2009. Per the terms of the contract, full ownership of the shares will only transfer to Mr X upon full payment of the purchase price, namely R50,000. The purchase price will be paid over in a series of instalments and will not be funded by way of a loan from ABC Limited or the share trust. Mr X makes payment on the final instalment on

30 June 2014 and takes ownership of the 1,000 shares (market value per share is R170 at the time of ownership transfer). The right to acquire the shares, as well as the shares themselves, will be subject to the same terms and restrictions as per the case study in part 8.1 above.

Figure 4.3: Timeline of the deferred delivery share scheme case study



8.3.2 Tax implications

- (1) The gain of R30,000 realised on the date of the acquisition of the right to acquire shares in ABC Limited will be included in Mr X's gross income in terms of paragraph (c) of the gross income definition, as the gain was realised by Mr X due to his employment with ABC Limited. However, the gain will be exempt from tax under section 10(1)(nD) of the Act as the shares have not yet vested. The tax treatment of this gain will be the same as that under the share purchase scheme contemplated in part 8.2 above.
- (2) Similar to the share purchase scheme in part 8.2, the gain of R50,000 made upon the exercise of the right to acquire the shares in ABC Limited, will be excluded from Mr X's income because an exchange of two restricted equity instruments is not regarded as constituting a vesting event. However, it is important to note that ownership of the shares will not pass to Mr X until full and final payment has been made for the shares. In the deferred delivery scheme, payment for the shares is deferred over time in order to give Mr X the opportunity to fund the purchase price of the shares without the use of a loan. Ownership of the shares, as well as the entitlement to dividends and voting rights, will not pass to Mr X until 30 June 2014,

when full payment has been made. As there is no loan from the share trust to fund the purchase price of the shares, there will be no potential for a taxable benefit in terms of paragraph 2(f) and 11 of the Seventh Schedule relating to low-interest or interest free loans.

- (3) Unlike the share option scheme and the share purchase scheme in parts 8.1 and 8.2, respectively, Mr X will not be entitled to receive any dividends declared by ABC Limited under the deferred delivery share scheme because ownership of the shares have not transferred to Mr X on the dividend declaration dates. Mr X will, therefore, not be impacted on a tax basis by the dividends declared on 30 June 2010 and 30 June 2012.
- (4) Similar to the share option scheme in part 8.1 and the share purchase scheme in part 8.2, the gain made by Mr X (R100,000) on the day when the retention restriction is lifted will be included in the gross income of Mr X in terms of paragraph (c) of the gross income definition included in section 1 of the Act. However, Mr X will not be liable for tax on the gain realised, as section 10(1)(nD) exempts any gain from tax that was realised in terms of an unvested equity instrument as contemplated in section 8C.
- (5) Upon full payment of the purchase price, ownership of the shares will pass to Mr X on 30 June 2014. Although the ownership of the shares will only pass on 30 June 2014, the shares are deemed to have been acquired by Mr X on the date of exercising the right to acquire the shares, namely 1 January 2010. This is supported by decision of the Appellate Division in the *Secretary for Inland Revenue v Hartzenberg* case where the word 'acquire' was assigned its wider meaning, which includes the acquisition of a *jus in personam ad rem acquirendam* (*Secretary for Inland Revenue v Hartzenberg*, 1966 1 All SA 626 (A):629). Based on this authority, it can be deemed that Mr X acquired the shares, for the purposes of section 8C, at the date when he exercised his right to acquire the shares. In this case, the date of acquisition of the shares will have no impact on the taxable income of Mr X, as the shares had not yet vested at the time of ownership transfer. However, should the disposal restrictions have been lifted prior to 30 June 2014, the gain at vesting would still have been included in Mr X's taxable income at that

date. The gain of R120,000 realised at the date of the transfer of ownership will not be included in Mr X's income because the shares have not yet vested and will remain restricted equity instruments (market value per share of R170 less the option grant price of R50).

- (6) The tax treatment of the gain upon the vesting of the shares in the deferred delivery share scheme will be the same as that contemplated in the share option scheme and share purchase schemes, included in parts 8.1 and 8.2, respectively. The gain of R130,000 made by Mr X on 1 January 2015 will be included in his income, as per section 8C(2)(a)(ii).
- (7) The capital gains tax implications of the sale of the shares in 2017 by Mr X will be the same as those contemplated in parts 8.1 and 8.2 for the share option scheme and share purchase scheme, respectively. A capital gain of R3,330 will be included in the taxable income of Mr X, calculated as 33.3 per cent of the capital gain of R40,000 less the annual exclusion allowed to natural persons by paragraph 5(1) of the Eighth Schedule, which amounts to R30,000.

The total taxable income earned by Mr X due to his participation in the share purchase scheme offered by ABC Limited will be R133,330, made up as follows:

<i>(1) Granting of right to Mr X (R30,000 gain exempt per ss10(1)(nD))</i>	<i>R 0</i>
<i>(2) Exercise of right by Mr X (R50,000 gain, no vesting has taken place)</i>	<i>R 0</i>
<i>(3) No dividend entitlement prior to 30 June 2014 due lack of ownership</i>	<i>R 0</i>
<i>(4) Retention restriction lifted (R100,000 gain, no vesting has taken place)</i>	<i>R 0</i>
<i>(5) Ownership transfers (R120,000 gain, no vesting has taken place)</i>	<i>R 0</i>
<i>(6) Disposal restriction lifted and vesting occurs (R130,000 gain per s 8C(2)(a)(ii))</i>	<i>R 130,000</i>
<i>(7) Capital gain upon disposal (R40,000 gain less R30,000 exclusion x 33.3%)</i>	<i>R 3,330</i>
<i>Total taxable income (from 2009 to 2017)</i>	<u><u><i>R133,330</i></u></u>

8.4 Phantom share scheme

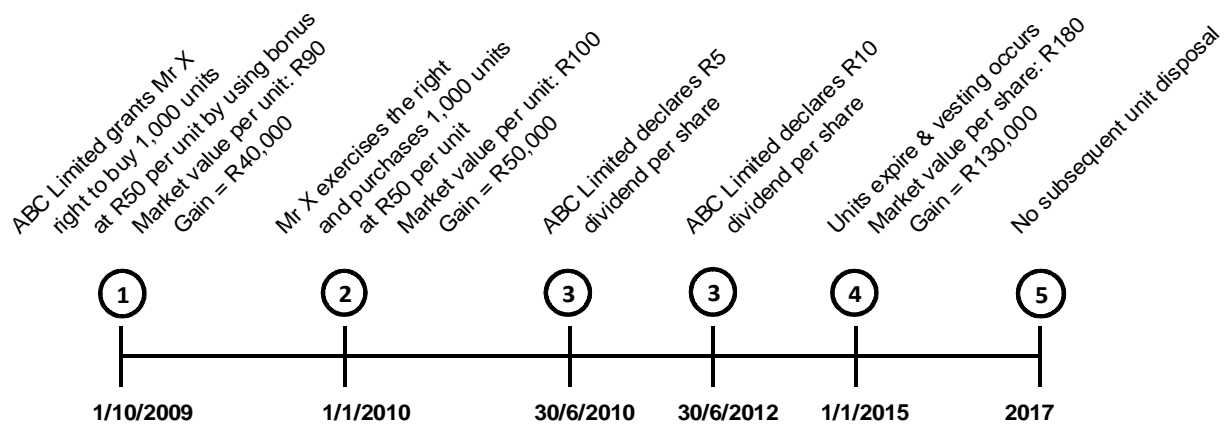
8.4.1 Case study

As per the case studies in parts 8.1 to 8.3 above, Mr X is an employee of ABC Limited, a South African resident company with a share trust that administers its share incentive scheme. However, unlike the case studies in parts 8.1 to 8.3, there are no actual shares in the phantom share scheme. In the phantom share scheme, Mr X will be offered phantom shares or units in the place of actual shares. However, the units will have no voting rights or any other distribution rights attached to them. At the time when the units expire or are disposed of, Mr X will receive a payment equivalent to the change in value of the shares from the time of acquisition to the time of disposal.

Mr X becomes entitled to a bonus amounting to R50,000 on 1 October 2009. Mr X is given the option by ABC Limited to take the bonus in cash or to utilise the bonus to acquire 1,000 units at R50 per unit. The units are linked to the value of the share capital of ABC Limited. Mr X is given a period of three months in which to decide whether he will take the cash bonus or the units in the phantom share scheme. Mr X exercises his right and acquires 1,000 shares by using his bonus on 1 January 2010. In order to hold the units, Mr X must remain in the employment of ABC Limited. Should Mr X leave ABC Limited, the units will expire at the date of Mr X's exit from the company. The units do not have an indefinite lifespan and will expire on 1 January 2015 (five years after acquisition).

ABC Limited declares dividends amounting to R5 and R10 per unit on 30 June 2010 and 30 June 2012, respectively. ABC Limited determines the value of the units on an annual basis at 1 January, or as required by the scheme. The market value per unit is as follows for each of the applicable dates:

- 1 October 2009: R90
- 1 January 2010: R100
- 1 January 2015: R180

Figure 4.4: Timeline of the phantom share scheme case study

8.4.2 Tax implications

- (1) Mr X becomes entitled to an annual bonus amounting to R50,000 on 1 October 2009. Mr X is given the choice of taking the annual bonus in cash or converting the bonus to units linked to the share capital value of ABC Limited. Should Mr X choose to take the cash bonus, he will receive the bonus of R50,000 net of his personal maximum marginal tax rate. However, in the case study, Mr X chooses to exercise his right to acquire the 1,000 units through the utilisation of his bonus to pay for the units. The acquisition of the right to acquire units by Mr X will not give rise to a tax event on 1 October 2009, as section 10(1)(nD) exempts the receipt of an unvested equity instrument from tax (Republic of South Africa, 1962). As with the share purchase scheme and deferred delivery share scheme in parts 8.2 and 8.3, respectively, the right to acquire the units will be an equity instrument as defined in section 8C(7) (Republic of South Africa, 1962). The unit will be a restricted equity instrument as per subsection (a) of the definition included in section 8C(7), as Mr X is not free to dispose of the units at any time as they are set to expire on 1 January 2015.
- (2) Mr X exercises the right to acquire the 1,000 units on 1 January 2010 and makes a gain of R50,000 at the acquisition (market value of R100 less the unit grant price of R50). However, as the units have not vested at the date of acquisition and remain restricted equity instruments, the gain will not be included in Mr X's income because no vesting has taken place. It should be noted that Mr X will be able to utilise the full

value of his annual bonus, namely R50,000, to acquire the 1,000 units if the bonus is not paid out to Mr X before the acquisition of the units. If Mr X utilises the bonus paid to him by ABC Limited or the share trust to acquire the units, he will do so utilising the post-tax bonus of R30,000. However, as per the case study, Mr X converts his annual bonus into units and no physical cash payment is made between Mr X and ABC Limited or the share trust, resulting in the full annual bonus being allocated to the acquisition of the units.

- (3) Mr X is entitled to receive both the dividends declared by ABC Limited on 30 June 2010 and 30 June 2012. However, only the dividend received by Mr X on 30 June 2010 will be exempt from tax under the provisions of the old section 10(1)(k)(i). Per the amendments made by the Taxation Laws Amendment Acts of 2010 and 2011, dividends received by participants of a phantom share scheme are no longer exempt from tax. The dividend exemption provision for local dividends received by South African residents was amended in 2010, and again subsequently in 2011, to specifically exclude dividends received in respect of a restricted equity instrument as contemplated in section 8C, which does not constitute an equity share as defined (Republic of South Africa, 2010b:44). Although the units acquired by Mr X are linked to the value of the share capital of ABC Limited, the unit itself will not carry the right to participate in a distribution beyond a specified amount. This fact results in the units falling out of the definition of an equity share as included in section 1 of the Act. Based on the above, Mr X will have to include the dividend of R10,000 received on 30 June 2012 in his taxable income, but may exclude the dividend of R5,000 as the dividend was declared and received prior to the effective date of the section 10(1)(k)(i) amendment, namely 1 January 2011.
- (4) The units acquired by Mr X reach the end of their lifespan of five years on 1 January 2015 and expire. As per section 8C(3)(b)(ii), the restriction on the disposal of the unit is lifted as the unit has expired. Mr X is paid an amount equal to the difference between the market value of the unit (R180 per unit), namely the value calculated by ABC Limited based on the value of its share capital, and the unit grant price of R50. The gain under section 8C(2)(a)(ii) will be R130,000 and will be included in the taxable income of Mr X on 1 January 2015. It should be noted that should Mr X have left the employment of ABC Limited prior to the expiration of

the units on 1 January 2015, vesting would have occurred at the resignation date and the gain, as calculated using the market value at such a date, would have been included in the income of Mr X.

- (5) Unlike the share incentive schemes contemplated in parts 8.1 to 8.3, no capital gain will be recognised under the phantom share scheme as the units expire at the end of their lifespan. Consequently, Mr X will be unable to dispose of the units after vesting as the units will cease to exist upon expiration.

The total taxable income earned by Mr X due to his participation in the share purchase scheme offered by ABC Limited will be R140,000, made up as follows:

<i>(1) Granting of right to Mr X (R40,000 gain exempt per s 10(1)(nD))</i>	<i>R 0</i>
<i>(2) Exercise of right by Mr X (R50,000 gain, no vesting has taken place)</i>	<i>R 0</i>
<i>(3) Dividend received on 30 June 2010 (R5,000 exempt per s 10(1)(k)(i))</i>	<i>R 0</i>
<i> Dividend received on 30 June 2012 (R10,000 not exempt per s 10(1)(k)(i)(dd))</i>	<i>R 10,000</i>
<i>(4) Units expire & vesting occurs (R130,000 gain per s 8C(2)(a)(ii))</i>	<i>R 130,000</i>
<i>(5) No capital gain as no disposal (R0)</i>	<i>R 0</i>
<i>Total taxable income (from 2009 to 2017)</i>	<u><u><i>R140,000</i></u></u>

9 Tax efficiency comparison and conclusion

The case studies set out in part 8 above illustrate the tax consequences of each of the four selected share incentive schemes, based on legislation contained in the Act, which will have a potential unique impact on each of the four schemes. Based on the case study results above, it can be seen that the share option and deferred delivery share schemes are most tax efficient based on the current income tax legislation of South Africa. The share purchase scheme is the least tax efficient scheme, given the circumstances where an interest-free or low-interest loan is granted to the employee. The phantom share scheme provides the employee with the second most tax efficient option and will rank in the middle of the four selected share incentive schemes in terms of overall tax efficiency.

However, the current ranking of tax efficiency of the four selected share incentive schemes is primarily due to the amendment of the dividend exemption provision contained in section

10(1)(k)(i). Prior to the inclusion of section 10(1)(k)(i)(dd) in 2011, the phantom share scheme would have been the most tax efficient scheme of the four selected share incentive schemes. This is because only the gain upon vesting would have been included in the employee's taxable income in terms of section 8C. However, the amendment to the dividend exemption has eliminated a large part of what made this scheme so tax efficient, namely tax-free returns on the employee's investment.

Although the share option scheme has been shown to be one of the most tax efficient of the selected share incentive schemes, as demonstrated by the case studies, a large portion of what made the scheme so tax efficient was eliminated by the replacement of section 8A by section 8C. The share option scheme was originally designed so that the gain made by the employee was included in such employee's taxable income as soon as possible, namely the exercise date, so that the resultant gain would be small. A similar circumstance befalls the deferred delivery share scheme, whereby a previously small gain under section 8A is now larger under the provisions of section 8C. Through the amendments made to section 8C over the years since its implementation in the 2005 year of assessment, most of the unintended strict provisions have been rewritten by the SARS, resulting in the taxation across the various share incentive schemes being fairly similar.

Based on the income tax legislation, along with the case studies included for illustrative purposes, the share option scheme and the deferred delivery share scheme are deemed to be the most tax efficient for the employee.

CHAPTER 5: CONCLUSION

1	Introduction	76
2	The motivation of share incentive schemes	76
3	The development of tax legislation relevant to share incentive schemes	77
4	Share incentive schemes and their tax implications	79
4.1	Share option scheme	79
4.2	Share purchase scheme	80
4.3	Deferred delivery share scheme	81
4.4	Phantom share scheme	82
5	Conclusion and recommendation	84

CHAPTER 5: CONCLUSION

1 Introduction

This study sought to analyse and evaluate the tax efficiency of the four most common share incentive schemes found in South Africa in relation to employees. This was accomplished through an execution of a literature review that considered past and present legislation, court judgments and various other literature sources relating to share incentive schemes. The motivation of employers offering and employees participating in such share incentive schemes was analysed to determine why share incentive schemes are still used in practice to remunerate employees. The mechanics of the four most common share incentive schemes were examined, along with relevant tax legislation, in order to determine the tax implications, and ultimately the tax efficiency, of each of the selected schemes.

2 The motivation of share incentive schemes

It was found that one of the principal motivations for employers offering share incentive schemes to employees as part of their remuneration package was the reduction or elimination of the agency theory, namely aligning the interests of the employees with those of shareholders and the company. By offering the employees a stake in the business, the employer effectively aligns the interests of the employees with those of the company. When the employees have an interest in the success of the business, they are more motivated to increase their efforts to grow profits and increase the value of the company, thereby realising a gain for themselves. It is this potential gain that is noted as one of the employee's leading motivations for participating in share incentive schemes offered by their employer. The opportunity to invest in their financial future is seen as a rare and valuable opportunity by employees. Although it may be difficult to see the direct effect of the employee's efforts on the growth in the value of the company, the employee's hard work will contribute to the potential profitability of the company resulting in the employee being able to have a hand in growing his or her own financial growth.

It was noted that employees want to feel engaged at work rather than just locked into their employment. Participation in a share incentive scheme gives employees the ability to have

a hand in the success of the company due to their contributions and hard work. When employees feel engaged, there is a positive impact on their attitude and focus, which results in a higher level of productivity at work and an increase in company loyalty. Although this is a large benefit for the employee, the employer will enjoy the fruits of increased employee productivity leading to an upturn in overall company performance and profitability.

It is these benefits that result in employers offering share incentive schemes, not only to experience increases in employee productivity, engagement and company growth, but also to retain these employees and attract potential employees to the company. The employer will put vesting conditions in place to ensure that employees are deterred from leaving the company's employment, resulting in the loss of benefits that the share incentive scheme provides. Such vesting conditions lead to employers being able to retain employees, while such employees benefit from remaining with the employer for a longer period of time through financial growth. Employers who wish to attract quality employees will be required to offer the option of participation in a share incentive scheme as part of the remuneration package. Employers who do not offer such remuneration packages will lose their competitive edge in the market, as high value employees are more likely to seek employment with companies offering such comprehensive remuneration.

The motivation of both employers offering and employees participating in share incentive schemes has resulted in such schemes being prevalent in the marketplace. Inevitably, such prevalence results in the governance of such schemes becoming more stringent, specifically relating to taxation, as pointed out by the study.

3 The development of tax legislation relevant to share incentive schemes

The progression of the tax legislation governing share incentive schemes was analysed in the study. The popularity of share incentive schemes grew in the 1950s through the 1960s due to the lack of specific legislation taxing such schemes. Gains realised by employees participating in share incentive schemes were taxed at the time the option or right accrued to the employee, resulting in a small tax liability. Any gain realised by the employee upon the disposal of the option, right or share was treated as a capital gain and taxed in terms of the Eighth Schedule to the Act. However, through the introduction of section 8A in 1969,

the Revenue sought to put a stop the limited taxes previously collected. Section 8A taxed the gain realised by the employee at the time the option was exercised. Although this resulted in a larger tax liability for the employee, the SARS still was not collecting tax on the full gain ultimately realised by the employee, namely the gain made upon vesting.

Section 8C, effectively introduced from 26 October 2004, included the gain realised by the employee upon the vesting of the option, right or other equity instrument in the employee's income, provided that such equity instrument was not replaced by another equity instrument. The exemption in section 10(1)(nD) ensured that any gain realised prior to the vesting of the equity instrument remained exempt from tax until all restrictions to which such equity instrument was subjected had been lifted and the instrument vested in the employee. The SARS has amended section 8C several times over the years since its introduction, resulting in more share incentive schemes falling within its ambit, such as the phantom share scheme. Due to the amendments, the SARS has successfully narrowed, or eliminated, the loopholes previously exploited by employers to legally circumvent the provisions of the Act and reduce the tax liability to be paid by participating employees.

However, as noted in the study, the amendment to the dividend exemption included in section 10(1)(k)(i) has had one of the biggest impacts on the taxation of share incentive schemes. Per section 10(1)(k)(i)(dd), certain dividends paid out in terms of share incentive schemes governed by section 8C will no longer be exempt from tax. The amended dividend exemption exempts any dividend paid to an employee in terms of a share incentive scheme if such a dividend is derived from an equity instrument that is an equity share, constitutes another equity instrument or is an interest in a trust that holds only equity shares. An example of a dividend that will no longer be exempt is a dividend paid to an employee under a phantom share scheme.

Employers are being forced to redesign and restructure their existing share incentive schemes to deal with the amendments made to section 8C and section 10(1)(k)(i), as previously tax efficient schemes are no longer granting the employees lower tax liabilities.

4 Share incentive schemes and their tax implications

The study analysed the four most common share incentive schemes and calculated the tax liability of each scheme, given the same set of circumstances and applying the current tax legislation found in the Act. The four share incentive schemes selected are the share option scheme, the share purchase scheme, the deferred delivery share scheme and the phantom share scheme.

4.1 *Share option scheme*

It was established that in a share option scheme the employer will grant the employee the option to acquire a fixed number of shares at a predetermined fixed price at a fixed future date. The employee is under no obligation to exercise the option, but should he or she choose to do so, full payment must be made to the employer upon exercise of the option, at which time full ownership of the shares will pass to the employee. The share option scheme was originally designed to grant the employee a performance-based remuneration, which attracts little to no tax under the tax legislation prior to the introduction of section 8C. Prior to section 8A, the share option scheme would attract no tax liability for the employee if the option was granted at a price equal to market value, as the employee would not realise a gain. However, under section 8A, the employee would have attracted a small tax liability on the gain realised, being the difference between the market value at the time of exercising the option and the option price. Section 8C changed these scenarios completely and results in the employee incurring a tax liability much larger than before, as the full gain at the vesting of the shares, rather than the options, will be taxed.

Current share option schemes could potentially result in a tax liability for the participating employee at three points in time, namely: the vesting of the shares in the employee; receipt of dividends under the scheme; and the subsequent sale of the shares after vesting. The amount of tax incurred by the employee upon vesting will be largely dependent on the time elapsed between the granting of the option and the date of vesting. This is because the longer the time period to vesting, the larger the potential movement in market value of the shares, resulting in a potentially larger gain realised by the employee. Conversely, if the market value of the shares decreased during the period between the granting of the option and the date of vesting, the loss to be deducted from the employee's

income would be larger given a longer period of time to vesting. It was established in the study that if the share option scheme is structured utilising equity share capital, any dividends received by the employee in terms of the share option scheme will remain exempt from tax in terms of section 10(1)(k)(i)(dd). However, if the employer structures the scheme utilising preference shares, no such dividend exemption will be available to the employee, as the preference shares will not be equity shares as defined in section 1 of the Act. The gain realised by the employee subsequent to vesting will be subject to capital gains tax in terms of the Eighth Schedule to the Act. However, the employee will be entitled to an annual exclusion amounting to R30,000, which could lead to no capital gain being included in the employee's taxable income if the capital gain is less than the annual exclusion amount.

4.2 *Share purchase scheme*

It was found that the share purchase scheme is currently the least tax efficient if the employer or its share trust offers a low interest rate or interest-free loan to the employee in order to purchase the shares offered. The share purchase scheme makes use of a share trust function, whereby a share trust is set up by the employer with the sole purpose of administering the share purchase scheme and holding shares on behalf of the participating employees. The share trust grants the employee the right to purchase shares in the employer at a predetermined fixed price at a fixed date in the future. A loan is granted by the share trust to the employee in order to purchase the shares, if the right is exercised by the employee, and ownership of the shares will pass to the employee upon acquisition of the shares. The loan can be granted to the employee at a market-related interest rate, at a lower interest rate or at no interest upon the discretion of the employer. Should the loan be granted at a lower than market-related interest rate or for no interest, the employee will be deemed to have received a fringe benefit from the share trust and will be required to include the cash equivalent of such benefit in his or her taxable income.

It was established that current share purchase schemes would result in a tax liability for the employee at the following dates: vesting of the shares in the employee; each year of assessment in which the employee is deemed to have received the fringe benefit of a low or no interest loan; upon receipt of any dividends declared under the scheme; and upon the subsequent disposal of the shares after vesting. As noted under the share option

scheme, the gain to be included in the income of the employee in terms of the share purchase scheme at vesting will be dependent on the movement of the market value of the underlying shares between the date of the offer to participate in the scheme and the vesting date. The longer the period between grant and vesting, the larger the potential gain to be included in or loss to be deducted from the income of the employee.

It was found that in scenarios where the share trust grants a low interest or interest-free loan to the employee to purchase the shares, the employee would incur a fringe benefit in terms of the Seventh Schedule to the Act. The cash equivalent of such a benefit would be the difference between the interest payable on the loan at the official interest rate and the amount of interest actually paid by the employee. The lower the interest rate on the loan granted to the employee, the larger the cash equivalent to be included in the employee's taxable income. However, if the loan was granted to the employee at a market-related interest rate, namely the official interest rate, the employee would not incur an additional tax liability.

It was also noted, as is the case under the share option scheme, that any dividend received under the share purchase scheme in respect of a restricted equity instrument that is not an equity share will no longer be exempt by section 10(1)(k)(i). Consequently, the share purchase scheme would be required to be structured in such a way that the shares purchased by the employee are equity shares so that any dividends paid out by the employer would remain exempt from tax for the employee.

The capital gain realised by the employee, should he or she dispose of the shares subsequent to vesting, will be the difference between the market value of the shares at the time of disposal less the market value of the shares at the time of vesting, namely the base cost as determined by paragraph 20(1)(h) of the Eighth Schedule to the Act. Should the gain exceed the annual exclusion of R30,000, the amount to be included in the taxable income of the employee will be the 33.3 per cent of the remaining capital gain.

4.3 Deferred delivery share scheme

The deferred delivery share scheme grants the employee the right to purchase a set number of shares at a predetermined fixed price at a specific date in the future. However,

unlike the share purchase scheme, the deferred delivery share scheme does not utilise a loan in its structure as the employee is given the opportunity to make payments over a period of time in instalments. The payments will be made to the employer or share trust and ownership of the shares will only pass to the employee upon receipt of full payment. Until the date of ownership transfer, the employee will not be entitled to receive dividends on the shares. The deferred delivery share scheme was originally designed to take advantage of the provisions of section 8A, which dictated that the gain realised by the employee would be included in his or her income upon the exercise of the right to purchase shares. The employee would be given a short period of time to exercise the right and the gain would be relatively small as the market value of the share would not have increased significantly during the period between the granting and exercise date. Section 8C put an end to the benefit of the small gain realised for tax purposes under the deferred delivery share scheme.

It was ascertained that the current deferred delivery scheme would result in a tax liability for the employee at the following points in time: vesting of the shares in the employee; upon receipt of any dividends declared under the scheme after the transfer of ownership; and upon the subsequent disposal of the shares after vesting. The gain realised upon vesting would be determined as the market value at the date of vesting less the consideration paid for the right to purchase the shares, namely the price of the right at the grant date. The size of the gain will be dependent on the change in the market value, as well as the amount of time elapsed, since the time of granting. As founded under the share option and share purchase schemes, any dividend received by the employee in terms of a share incentive scheme governed in terms of section 8C will only be exempt from tax if such dividend resulted from an equity share. The capital gain realised by the employee upon disposal of the shares after vesting will be included in the taxable income of the employee, after the deduction of the annual exclusion, at a rate of 33.3 per cent.

4.4 Phantom share scheme

It was established that the phantom share scheme is not a share incentive scheme in the true sense as the employer or share trust will grant the employee the right to acquire units linked the value of the share capital of the employer, rather than actual shares. Employees are granted the option to utilise their cash bonuses to purchase units or are given units to

the value of their cash bonuses. Consequently, there is no capital outlay for the employee to purchase the units. By issuing units instead of shares, the employer does not experience any dilution in share capital. The phantom share scheme was originally designed to fall out of the scope of section 8C, as the initial wording of the section did not make provision for structures where units were utilised rather than shares. However, the SARS swiftly closed the loophole by amending the definition of an equity instrument in section 8C(7) and phantom share schemes are now governed by the provisions of section 8C.

It was determined that the phantom share scheme would attract a tax liability for the employee at the following points in time, namely at the date of vesting of the units in the employee and upon receipt of any dividends under the scheme. Unlike the share option, share purchase and deferred delivery share schemes, the phantom share scheme does not attract capital gains tax under the Eighth Schedule to the Act, as the employee is not able to dispose of the units subsequent to vesting as the units will expire upon vesting. The expiration of the units upon vesting is a characteristic unique to the phantom share scheme.

The gain realised by the employee upon vesting of the units will be the difference between the market value of the underlying share capital to which the unit is linked less the consideration paid by the employee to acquire the units, namely the cash bonus utilised. Like the three previously discussed schemes, the size of the gain will be dependent upon the change in market value along with the amount of time elapsed between the granting of the units and the vesting date. Any dividends received by the employee under the phantom share scheme will not be exempt from tax under section 10(1)(k)(i). Although the units may be linked to the value of an equity share, the dividends paid to the employee will be the result of the employee holding units rather than the equity shares. Consequently, such dividends do not fall within the exempting scope of the section 10(1)(k)(i) provision. This is an amendment that will result in employers having to restructure or terminate their phantom share schemes as the schemes will no longer be as tax efficient for the participating employees.

5 Conclusion and recommendation

It was concluded that the share option scheme and deferred delivery share scheme are currently the most tax efficient schemes for employees. Based on the case studies included in Chapter 4, along with an analysis of the current legislation contained in the Act relevant to share incentive schemes, the share option and deferred delivery share schemes resulted in the lowest overall tax liability for employees. The phantom share scheme was noted to be the median of the four selected schemes in terms of tax efficiency. This is largely due to the amendment of the dividend exemption provision, as all phantom share scheme dividends are now taxable. The share purchase scheme will be the least tax efficient of the four schemes in scenarios where the employer grants the employee a low or interest-free loan to purchase the shares offered. Should the employer grant a market-related interest rate loan, the share purchase scheme will be on par with the share option and deferred delivery share schemes in terms of tax efficiency, as all three schemes will result in the same tax liability for the employee.

The SARS has focused its attention on the taxation of share incentive schemes since its introduction of section 8C in the 2005 year of assessment, as evidenced by the amendments made to the section on an annual basis. Due to these continued amendments to close any remaining loopholes in the legislation, the various share incentive schemes have been brought onto a level playing ground, resulting in a virtually equal tax liability under each scheme. The exception is the phantom share scheme, which has been most affected by the amendment to the dividend exemption provision.

It was found that employers will be required to revisit the structuring of their current share incentive schemes to ensure that any share utilised in the scheme is an equity share. This consideration will be vitally important to ensure that any dividend received by employees under the schemes remains exempt from tax. Should employers not take this amendment into account in structuring their share incentive schemes, the tax efficiency of the scheme for the employee will be adversely affected.

It is recommended that employers revisit the restrictions placed upon the equity instruments held by employees under their share incentive schemes in order for the schemes to remain tax efficient. In order for the tax liability to be reduced upon vesting,

such restrictions should be lifted at an earlier date to limit the gains realised by employees under the share incentive schemes. However, this objective is contrary to the business objective of the employer wishing to retain employees. It may be necessary for the employer to seek alternative methods of employee retention, such as deferred bonus payments, to achieve the business objective.

BIBLIOGRAPHY

1	Acts, Bills, Interpretation Notes and Accounting Standards	87
2	Books	88
3	Electronic databases	88
4	Journal articles	88
5	Dissertation, assignments and theses	90
6	Websites	90
7	Court cases	95

BIBLIOGRAPHY

1 Acts, Bills, Interpretation Notes and Accounting Standards

IFRS Foundation. 2010. *International Financial Reporting Standard 2 – Share-based Payment*. <http://eifrs.ifrs.org/eifrs/bnstandards/en/2012/ifrs2.pdf> (Date of access: 30 October 2011).

Republic of South Africa. 1962. *Income Tax Act (Act no. 58 of 1962)*. <http://www.acts.co.za/tax/index.htm> (Date of access: 19 July 2012).

Republic of South Africa. 1969. *Income Tax Act (Act no. 89 of 1969)*. Pretoria: Government Printer.

Republic of South Africa. 1973. *Companies Act (Act no. 61 of 1973)*. <http://www.acts.co.za/company/index.htm> (Date of access: 24 June 2012).

Republic of South Africa. 2003. *Broad-Based Black Economic Empowerment Act (Act no. 53 of 2003)*. <http://www.acts.co.za/bbe2003/index.htm> (Date of access: 5 June 2012).

Republic of South Africa. 2004. *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004*. <http://www.treasury.gov.za/divisions/tfsie/tax/legislation/proposed/2004/RevenueLawsAmendmentBill24-2004Memo.pdf> (Date of access: 12 August 2012).

Republic of South Africa. 2005. *Revenue Laws Amendment Act, 2004*. <http://www.info.gov.za/view/DownloadFileAction?id=67971> (Date of access: 19 July 2012).

Republic of South Africa. 2008. *Companies Act (Act no. 71 of 2008)*. http://www.acts.co.za/companies_act_2008/index.htm (Date of access: 24 June 2012).

Republic of South Africa. 2010a. *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010*.

<http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=63735> (Date of access: 31 August 2011).

Republic of South Africa. 2010b. *Taxation Laws Amendment Act, 2010*. <http://www.sars.gov.za/home.asp?pid=2629> (Date of access: 31 August 2011).

Republic of South Africa. 2011. *Interpretation Note No. 55 (Issue 2)*. <http://www.sars.gov.za/home.asp?pid=55888> (Date of access: 19 July 2012).

Republic of South Africa. 2012a. *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011*. <http://www.sars.gov.za/home.asp?pid=2631> (Date of access: 27 August 2012).

Republic of South Africa. 2012b. *Taxation Laws Amendment Act, 2011*. <http://www.sars.gov.za/home.asp?pid=2629> (Date of access: 8 September 2012).

2 Books

Haupt, P. 2012. *Notes on South African Income Tax*. Cape Town: H & H Publications.

Stiglingh, M., Koekemoer, A., Van Schalkwyk, L., Wilcocks, J. & Swardt, R. 2012. *Silke: South African Income Tax*. Durban: LexisNexis.

3 Electronic databases

De Koker, A.P. & Williams, R.C. 2011. *Silke on South African Income Tax*. [http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) (Date of access: 14 July 2012).

4 Journal articles

Casey, M. 2002. *If stock-options grants didn't work, what will?* <http://online.wsj.com/article/0,,SB1030308720791740995,00.html> (Date of access: 10 August 2012).

Croome, B. 2003. Payroll World. *Remuneration structuring*. <http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll/kjxj/qf/ija/hzjn/szjn> (Date of access: 17 August 2012).

De La Bruslerie, H. & Deffains-Crapsky, C. 2008. Information asymmetry, contract design and process of negotiation: The stock options awarding case. *Journal of Corporate Finance*. 14: 73-91.

Du Plessis, I. 2005. Section 8C of the Income Tax Act: A discussion. *Stellenbosch Law Review*, 16(1):104-124.

Fuller, G. 2010. Fresh Growth. *Employee Benefits*. June 2010:44.

Jensen, M.C. & Meckling, W.H. 1976. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics*, 3: 305-360.

Jensen, M.C. & Murphy, K.J. 1990. Performance Pay and Top-Management Incentives. *Journal of Political Economy*, 98(2): 225-265.

Jones, D.C., Kalmi, P. & Mäkinen, M. 2006. *The productivity effects of stock option schemes: Evidence from Finnish panel data*. http://academics.hamilton.edu/economics/Home/workpap/06_11.pdf (Date of access: 10 June 2012).

Loughrey, Z. 2010. Share schemes can boost recovery effort. *Employee Benefits*. March 2010:25.

Muurling, R. & Lehnert, T. 2004. Option-based compensation: a survey. *The International Journal of Accounting*. 39: 365-401.

Oyer, P. & Schaefer, S. 2005. Why do some firms give stock options to all employees?: An empirical examination of alternative theories. *Journal of Financial Economics*. 76: 99-133.

Scholtz, H.E. 2009. *Share options as part of executive remuneration: aligning the interests of stakeholders*. <http://www.ajol.info/index.php/sabr/article/viewFile/76336/66793> (Date of access: 10 June 2012).

5 Dissertation, assignments and theses

Butler, E.E. 2005. *Employee Share incentive Schemes – The taxation of the old and the "new"*. Cape Town: University of Cape Town (H.Dip (Taxation): Technical Report).

Nyelisani, T.P. 2010. *Employee perceptions of share schemes*. Pretoria: Gordon Institute of Business Science, University of Pretoria (Master of Business Administration: dissertation).

Sacho, ZY. 2009. *Accounting for employee share options: a critical analysis*. Pretoria: University of South Africa (Master of Accounting Science: Dissertation).

Stafford, M. 2005. *The transition in the nature of tax consequences associated with share incentive schemes in South Africa*. Johannesburg: University of Witwatersrand (Master of Law in Taxation: Dissertation).

6 Websites

A Dictionary of Business and Management. n.d. Oxford. <http://www.highbeam.com/doc/1O18-shareincentivescheme.html> (Date of access: 18 September 2011).

Anon. n.d (a). *Employee stock options fact sheet*. <http://www.nceo.org/articles/employee-stock-options-factsheet> (Date of access: 10 June 2012).

Anon. n.d (b). *What are stock option plans?*. <http://www.investorguide.com/igu-article-501-employee-stock-options-what-are-stock-option-plans.html> (Date of access: 10 June 2012).

Anon. 2012. *Set up employee share schemes - An overview of the various employee share schemes*.

<http://www.nibusinessinfo.co.uk/bdotg/action/detail?itemId=1074481231&r.i=1074481071&r.l1=1073858787&r.l2=1084822773&r.l3=1074472937&r.s=sc&r.t=RESOURCES&site=191&type=RESOURCES> (Date of access: 10 June 2012)

Barlow, L. & McClarty, K. 2009. *Tax News: Are there still some good share schemes out there?* http://www.deloitte.com/assets/Dcom-SouthAfrica/Local%20Assets/Documents/za_Tax_taxNews3_030809.pdf (Date of access: 10 June 2012).

Blair, C. 2012. *Recent changes to share-based executive incentive plans.* <http://www.tradeinvestsa.co.za/business-opportunities/1191760.htm> (Date of access: 9 June 2012).

Blair, C. & De Beer, B. 2006. Accountancy SA. *Share-based Executive Incentive Schemes - The Performance, Retention, Shareholder Alignment dilemma.* <http://www.accountancysa.org.za/resources/ShowItemArticle.asp?Article=Share-based+incentives&ArticleId=983&Issue=659> (Date of access: 5 May 2009).

Bradley, J., Lynch, O., Jacobsen, G. & O'Brien, P.J.P. 2012. *Employee share incentive schemes.* <http://www.kpmg.com/IE/en/IssuesAndInsights/ArticlesPublications/Documents/Employment-Tax-Services/Employee-Share-Incentive-Schemes-May2012.pdf>)Date of access: 9 June 2012).

Brincker, E. 2011. *Tax impact of share incentive schemes law.* <http://www.businesslive.co.za/incoming/2011/03/09/tax-impact-of-share-incentive-schemes-law>. (Date of access: 18 September 2011).

BusinessDictionary. n.d. Share option. <http://www.businessdictionary.com/definition/share-option.html> (Date of access: 25 June 2012).

Casson, P. n.d. QFinance. *Employee stock options.* <http://www.qfinance.com/business-strategy-best-practice/employee-stock-options?page=1> (Date of access: 18 September 2011).

Croome, B. & Kretzmann, A. 2011. *The perils of share incentive schemes for employers*. http://www.ens.co.za/news/news_article.asp?iID=216&iType=4 (Date of access: 20 July 2012).

Gad, R., Coetzee, A., Farrand, H., Speirs, C. & Ellis, E. 2009. *Labour and Employee Benefits 2009/10 Volume 2: Employee Share Plans – South Africa*. <http://www.ens.co.za/newsletter/briefs/South%20Africa02.pdf> (Date of access: 9 June 2012).

Hansen, S.W. 2006. *Options Basics: Puts and Calls*. http://www.forbes.com/2006/08/23/investools-options-ge-in_wh_0823investools_inl.html. (Date of access: 5 October 2012).

Harraway, R. n.d. *Spotlight on share schemes*. <http://www.hrfuture.net/daily-article/spotlight-on-share-schemes.php?Itemid=114> (Date of access: 10 June 2012).

Icely, N. 2012. *What does the future hold for share schemes?*. <http://www.deloitte.com/assets/Dcom-SouthAfrica/Local%20Assets/Documents/Share%20Schemes%20Article%20lay%20out%205%20FINAL.pdf> (Date of access: 10 June 2012).

Icely, N. & Dicks, M. n.d. *New age incentive schemes*. http://www.deloitte.com/view/en_za/za/7ddbe60e612fb110VgnVCM100000ba42f00aRCRD.htm (Date of access: 9 June 2012).

Institute of Directors of Southern Africa. 2009. *King Report on Corporate Governance for South Africa – 2009*. <http://www.library.up.ac.za/law/docs/king111report.pdf> (Date of access: 1 August 2012).

Investopedia. 2012. Tax efficiency. <http://www.investopedia.com/terms/t/tax-efficiency.asp#axzz21x804QCD> (Date of access: 28 July 2012).

InvestorWords. Grant price. n.d. http://www.investorwords.com/11622/grant_price.html (Date of access: 25 June 2012).

Jones, D.C., Kalmi, P. & Mäkinen, M. 2006. *The Productivity Effects of Stock Option Schemes: Evidence from Finnish Panel Data*. http://academics.hamilton.edu/economics/Home/workpap/06_11.pdf (Date of access: 10 June 2012).

Langridge, C. 2009. *Employee share schemes*. http://www.crippslink.com/index.php?option=com_content&view=article&id=538:employee-share-schemes&catid=74:corporate-finance-publications&Itemid=537 (Date of access: 10 June 2012).

Lewis, A. 2011a. *Deferred delivery schemes scrutinised*. <http://www.taxtalkblog.com/?p=5139> (Date of access: 10 June 2012).

Lewis, A. 2011b. *Amendments affecting share incentive schemes*. http://www.fanews.co.za/article.asp?Tax_~16,Tax~1016,Amendments_affecting_share_incentive_schemes~10924 (Date of access: 26 August 2012).

Lewis, A. 2011c. *Dividends now taxable in certain share incentive schemes*. <http://www.polity.org.za/article/dividends-now-taxable-in-certain-share-incentive-schemes-2011-01-26> (Date of access: 18 September 2011).

Louw, H. 2012. *New definition of a 'share'*. http://www.fanews.co.za/article.asp?Tax_~16,Tax~1016,New_definition_of_a_share~12209 (Date of access: 26 August 2012).

Mazibuko, N.E. & Boshoff, C. 2003. Employee perceptions of share ownership schemes: An empirical study. *South African Journal of Business Management* 34(2):31, June. http://www.sabinet.co.za/abstracts/busman/busman_v34_n2_a4.html (Date of access: 9 June 2009).

Milovanovic, A. & Hoek, D. 2011. *Employee share plans: South Africa*. http://crossborder.practicallaw.com/1-503-4810?q=*&qp=&qo=&qe=#a677106 (Date of access: 10 June 2012).

Net Lawman. n.d. *Employee share schemes*. <http://www.netlawman.co.uk/info/employee-share-schemes.php> (Date of access: 10 June 2012).

Northern Ireland Business Info. n.d. *Set up employee share schemes – considerations for employees*.

<http://www.nibusinessinfo.co.uk/bdotg/action/detail?itemId=1074481071&site=191&type=R>
ESOURCES (Date of access: 10 June 2012).

Ownership Solutions. 2012. *Share appreciation rights schemes*. http://www.ownershipsolutions.co.za/Serv_SharIncScheme.aspx (Date of access: 10 June 2012).

Oxford University Press. 2011. *Oxford Advanced Learner's Dictionary*. <http://oald8.oxfordlearnersdictionaries.com/dictionary/efficiency> (Date of access: 17 August 2012).

Solomon, T. & Muller, A. 2010. *Employee share incentive schemes: the stop-loss anomaly*. http://www.ens.co.za/news/news_article.asp?iID=329&iType=4 (Date of access: 13 July 2012).

South African Revenue Service. 2012. *Interest Rates – Table 3*. <http://www.sars.gov.za/home.asp?pid=54745> (Date of access: 16 September 2012).

Spamer, S. & Burger, A. 2010. *Has government blown the final whistle on incentive schemes?* http://www.ens.co.za/news/news_article.asp?iID=405&iType=4 (Date of access: 10 June 2012).

The Employee Share Scheme Specialists. n.d. *Share incentive plan*. <http://www.employeeshareschemes.co.uk/plans-sip.aspx> (Date of access: 10 June 2012).

Van Eeden, R. 2011. *Employee's tax implications for share scheme losses*.
<http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page197?oid=62309&sn=Detail> (Date of access: 20 July 2012).

Younis & Co. 2012. *Want to motivate your employees to increase their productivity?*
<http://www.younisco.com.au/insights/hot-topics/want-to-motivate-your-employees-to-increase-their-productivity-%E2%80%93/> (Date of access: 10 June 2012).

7 Court cases

Income Tax Case No. 1493 [1989], 53 SATC 187 (T).
<http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll/lc/ff/qvc/7wc/0awb#ga> (Date of access: 12 August 2012).

Secretary for Inland Revenue v Hartzenberg [1966], 1 All SA 626 (A).
<http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll/cc/u0uua/ghvua/d2a1a/32a1a/8hd1a#g0> (Date of access: 16 September 2012).

Secretary for Inland Revenue v Kirsch [1978], 40 SATC 95.
<http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll/lc/ff/qvc/uwc/bcvb#ga> (Date of access: 29 August 2008).

Secretary for Inland Revenue v Kirsch [1978], (3) All SA 308 (T).
[http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://www.lib.sun.ac.za.ez.sun.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) (Date of access: 12 August 2012).