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

By

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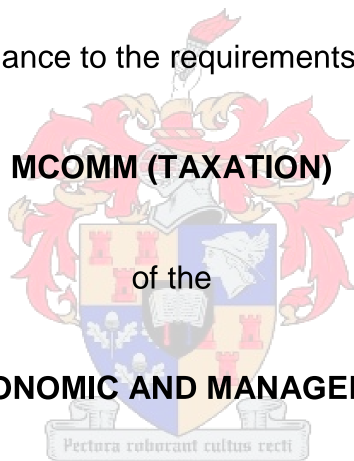
ASSIGNMENT

in partial compliance to the requirements for the degree



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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.

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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

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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.

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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

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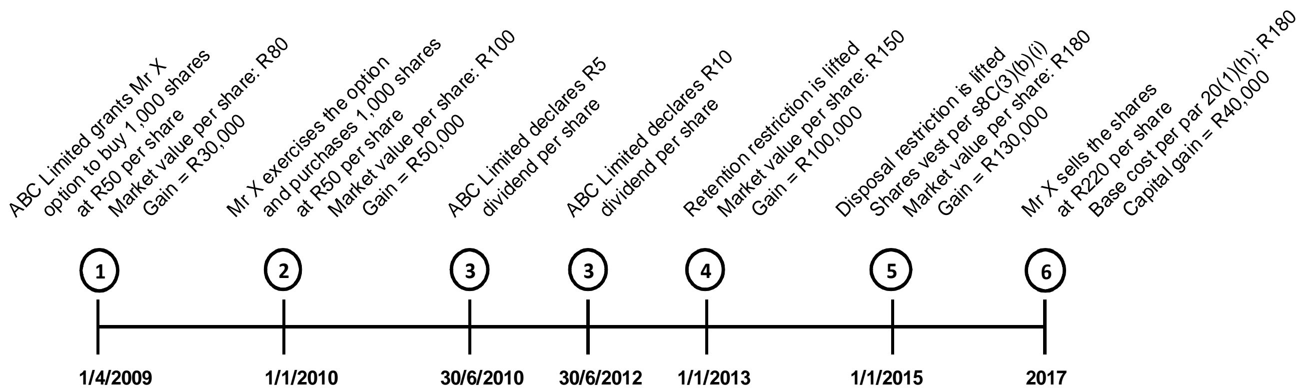
Figure 4.1: Timeline of the share option scheme case study



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.

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(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

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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)	*R133,330*

8.2 Share purchase scheme

8.2.1 Case study

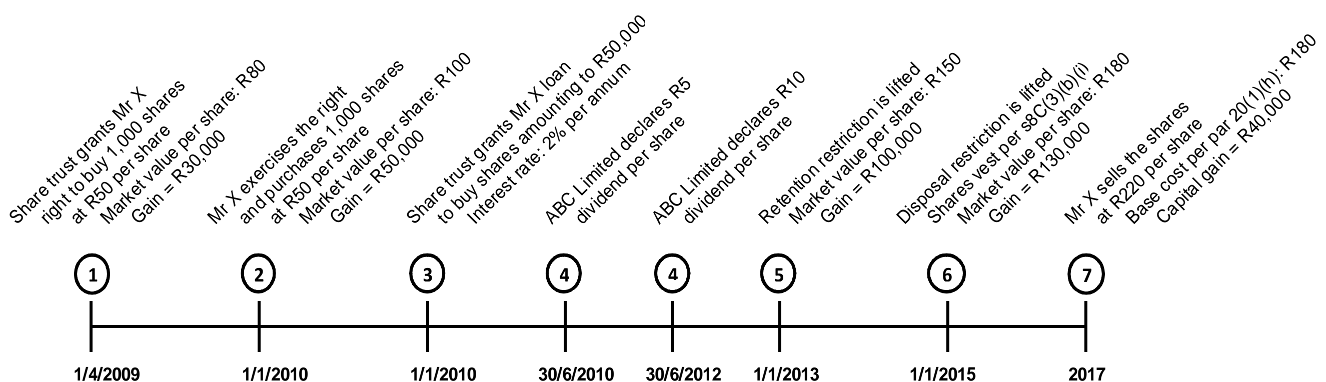
Mr X is an employee of ABC Limited, a South African resident company. ABC Limited establishes a share trust with the sole purpose to oversee and manage the administration of ABC Limited's share incentive scheme. ABC Limited transfers 100,000 shares to the share trust and grants a loan to the share trust 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

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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 is 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 x 8% x 9/12 = R3,000
  - Interest actually incurred: R50,000 x 2% x 9/12 = R750
- 1 October 2010 to 28 February 2011: cash equivalent = R1,041

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

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(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)	*R142,641*

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

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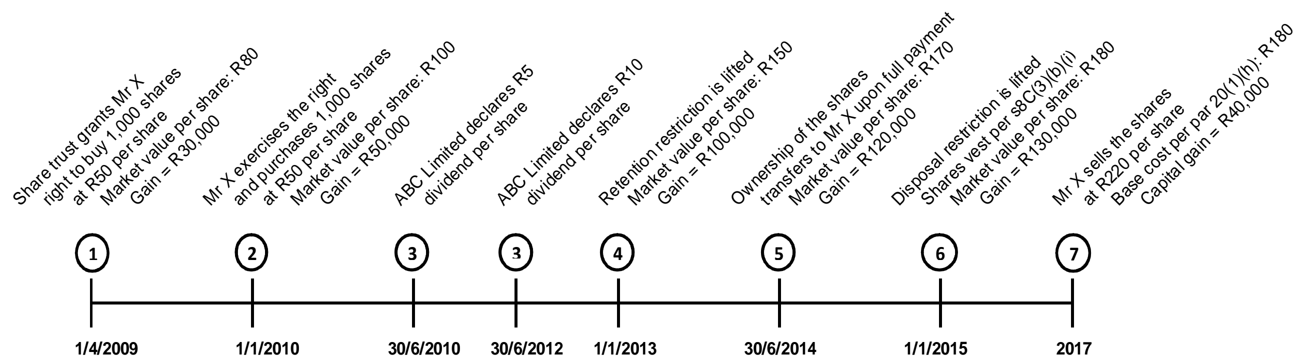
30 June 2014 and takes ownership of the 1,000 shares (market value per share is R170 at the time of ownership transfer). The right to acquire the shares, as well as the shares themselves, will be subject to the same terms and restrictions as per the case study in part 8.1 above.

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,

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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

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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:

(1) Granting of right to Mr X (R30,000 gain exempt per ss10(1)(nD))	*R 0*
(2) Exercise of right by Mr X (R50,000 gain, no vesting has taken place)	*R 0*
(3) No dividend entitlement prior to 30 June 2014 due lack of ownership	*R 0*
(4) Retention restriction lifted (R100,000 gain, no vesting has taken place)	*R 0*
(5) Ownership transfers (R120,000 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 x 33.3%)	*R 3,330*
Total taxable income (from 2009 to 2017)	*R133,330*

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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

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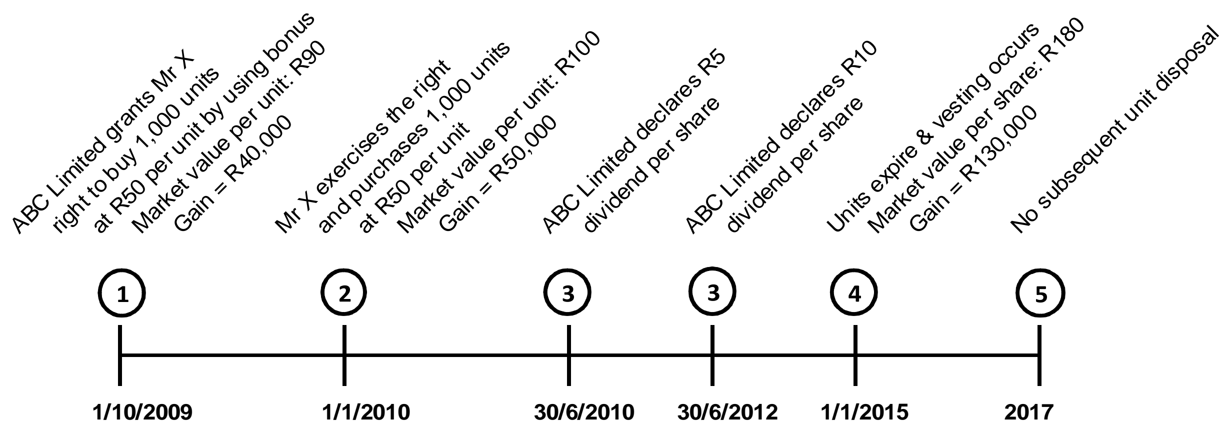
Figure 4.4: Timeline of the phantom share scheme case study



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

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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

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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:

(1) Granting of right to Mr X (R40,000 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) 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 not exempt per s 10(1)(k)(i)(dd))	*R 10,000*
(4) Units expire & vesting occurs (R130,000 gain per s 8C(2)(a)(ii))	*R 130,000*
(5) No capital gain as no disposal (R0)	*R 0*
Total taxable income (from 2009 to 2017)	*R140,000*

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

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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.

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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

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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,

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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.

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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

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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

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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,

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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

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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.

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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,

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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.

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