

# A CRITICAL ANALYSIS OF THE INCOME TAX IMPLICATIONS OF CONDITIONAL EMPLOYEE SHARE PLANS IN SOUTH AFRICA

by

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## ABSTRACT

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Employee share plans are commonly used to provide a staff incentive to employees who have served long and continuously, as well as to compensate the employees for their commitment in reaching company goals and performance criteria.

Because any person, including employers implementing such schemes, will always structure transactions to achieve the best possible tax outcome, many schemes and structures have become available to achieve those ends.

A recent employee share scheme was structured through the incorporation of a wholly-owned subsidiary, which was incorporated for the sole purpose of administering and managing the employee share plan on behalf of the holding company. This would include acquiring holding company shares in the open market and the subsequent transfer thereof to the holding company's employees. The payment made to the subsidiary for the services rendered and to enable the subsidiary to acquire holding company shares in the open market, was structured as a fee together with a risk premium payable and not as an intercompany interest-free loan.

A study of the investigation and evaluation of the adequacy and legality of such schemes and structures and whether or not appropriate tax principles were applied to achieve possible tax benefits, creates several research challenges.

Although previous research has been conducted on the tax implications for employees under a share-based plan, payments structured as interest-free loans and several case law on the deductibility of payments structured as interest-free loans, there is a lack of extensive previous academic research on the funding of employee share plans structured as a fee together with a risk premium, made to wholly-owned subsidiaries to manage and administer an employee share plan.

The aim of this study is to help to fill the gap in relevant research, case law and legislation regarding the tax implications of this new funding structure of conditional employee share plans. The tax implications for both the holding company and the subsidiary will be taken into consideration to assess whether or not the scheme will be beneficial to all parties involved.

Keywords:

*Conditional employee share plan*

*Company shares*

*Subsidiary*

*Interest-free loan*

## OPSOMMING

# 'N KRITIESE ANALISE VAN DIE INKOMSTEBELASTING-IMPLIKASIES VAN VOORWAARDELIKE AANDEELGEBASEERDE SKEMAS VIR WERKNEMERS IN SUID AFRIKA

deur

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Aandeelgebaseerde skemas vir werknemers word algemeen gebruik om personeelvoordele aan werknemers te verskaf wat lang en deurlopende diens gelewer het, asook om vergoeding te bied aan werknemers vir hul toewyding in die bereiking van die maatskappy se doelwitte en prestasie-kriteria.

Verskeie skemas en strukture het al ontstaan as gevolg van die feit dat enige persoon, onder wie werkgewers wat sulke skemas implementeer, deurgans transaksies sal struktureer om die beste moontlike belastinguitkoms te bewerkstellig.

'n Onlangse aandeelgebaseerde skema vir werknemers is soos volg gestruktureer: Die houermaatskappy het 'n volfiliaal ingelyf met die uitsluitlike doel om die administrasie en bestuur van die aandeelgebaseerde skema, namens die houermaatskappy te onderneem. Die verkryging van die houermaatskappy-aandele in die ope mark en die daaropvolgende oordrag daarvan aan die houermaatskappy se werknemers is beplan. Die betaling aan die filiaal vir die dienste gelewer en om die filiaal in staat te stel om die houermaatskappy se aandele in die ope mark te bekom, is gestruktureer as 'n fooi en 'n risiko-premie betaalbaar eerder as 'n rentevrye intergroep-lening as sodanig.

'n Studie oor die ondersoek en evaluering van die geskiktheid en wettigheid van sulke strukture en of die korrekte belastingbeginsels toegepas is om moontlike belastingvoordele te bereik, skep verskeie navorsingsuitdagings.

Hoewel vorige navorsing onderneem is oor die belastingimplikasies vir werknemers in die lig van aandeelgebaseerde transaksies, betalings wat gestruktureer is as rentevrye lenings en verskeie wetsbepalings ten opsigte van die aftrekbaarheid van betalings wat gestruktureer is as rentevrye lenings, is daar 'n gebrek aan uitgebreide vorige akademiese navorsing oor die befondsing van aandeelgebaseerde skemas deur 'n fooi insluitende 'n risikopremie.

Die doel van hierdie studie is om te help om die die gaping in relevante navorsing, regspraak en wetgewing ten opsigte van die belastingimplikasies van die nuwe finansieringstruktuur van voorwaardelike aandeelgebaseerde skemas vir werknemers te vernou. Die belastingimplikasies vir die houermaatskappy en filiaal sal in ag geneem word om vas te stel of die skema voordelig is vir albei die betrokke partye.

Sleutelwoorde:

*Voorwaardelike aandeelgebaseerde skema vir werknemers*

*Maatskappy-aandele*

*Filiaal*

*Rentevrye lening*

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## CHAPTER 1: INTRODUCTION AND PROBLEM STATEMENT

### 1.1 BACKGROUND

Employers are constantly looking for ways to improve and simplify their tax paying position. As German chancellor Angela Merkel, said “Everyone wants a more simple tax system. But if it means that certain tax breaks have to be cut; people are no longer so enthusiastic” (Woopidoo.com, n.d.)

The outsourcing of several functions within a business is a common practice in the execution of the day-to-day activities of companies. Outsourcing has become one of the most important and popular strategies in an increasingly competitive marketplace. “According to the Outsourcing Institute, companies are realising a 9% cost saving and a 15% increase in capacity and quality, on average, through outsourcing” (Matthew, 1998:2).

There has been an increase in the number of companies wishing to outsource the management and administration function of their employee share plans. This includes acquiring holding company shares in the open market and the subsequent transfer thereof to participants, at the relevant time as determined in the employee share plan. The outsourcing of these functions can be due to a number of reasons, namely:

- to free resources, to concentrate on the companies’ core business activities;
- to share governmental, economic or market and financial risks; or
- to outsource functions that cannot be managed effectively internally (Matthew, 1998:3-4).

Employee share plans are known to be an incentive to employees, where employees can obtain shares within the company and on this basis obtain participation rights within the company. These share plans are designed with the aim to secure a staff complement of employees serving a long and continuous service. In addition to long service requirements the granting of shares is usually conditional based upon certain performance criteria.

Because it may take several months to register an employee trust to administer the employee share plan on behalf of the holding company, it is now a common practice to

incorporate a private company in which the holding company acquires 100% of its ordinary shares.

In an interview conducted with Ms. A. Wilkin, senior clerk of Hentzel Services, on 22 June 2009, she advised that it would take at least 12 to 15 months to register a trust. In contrast to this it will take approximately 3 weeks to register a private company, according to an interview that was conducted with Ms. J Selix, a CIPRO consultant, on 22 June 2009.

The company would then incorporate a wholly-owned subsidiary to administer and manage the employee share plan on behalf of the holding company. This would include acquiring holding company shares in the open market and the subsequent transfer thereof to the holding company's employees. The payment made to the subsidiary, for the services rendered and to enable the subsidiary to acquire holding company shares in the open market, is structured as a fee together with a risk premium payable and not as an intercompany interest-free loan as such.

A comprehensive search was conducted on Google, EBSCOhost, Scholar and UPeTD, which indicated that while research has been conducted on the tax implications for employees under a share based plan (Bortz, 2006:1-28; Butler, 2005:1-23; Keirby-Smith, 2006:37), payments structured as interest-free loans (Hassan, 2008; Stark, 2008:145-158) and several case law on the deductibility of payments structured as interest-free loans (**CIR v Berold**, 1962 (3) SA 748 (A) (24 SATC 729); **CSARS v Brummeria Renaissance (Pty) Ltd and Others**, 2007 (SCA) (69 SATC 201); **CSARS v Wouldidge**, 2002 (1) SA 68 (SCA) (63 SATC 483)), there is a lack of extensive previous academic research on the funding of employee share plans structured as a fee together with a risk premium, made to wholly-owned subsidiaries to manage and administer an employee share plan.

Due to the lack of previous research as well as relevant case law, uncertainty exists as to the benefits and tax implications of funding the employee share plan through the funding structure, as explained above.

## 1.2 PROBLEM STATEMENT

Although several case law exists for the treatment of interest-free loans granted to companies (**CIR v Berold**, 1962 (3) SA 748 (A) (24 SATC 729); **CSARS v Brummeria Renaissance (Pty) Ltd and Others**, 2007 (SCA) (69 SATC 201); **CSARS v Wouldge**, 2002 (1) SA 68 (SCA) (63 SATC 483)), no case law or previous research exists to assist and to direct the interpretation of the relevant legislation governing the tax implications of the funding structure of employee share plans, where the payment is structured as a fee together with a risk premium, to obtain possible tax deductions and in turn place the company in a better tax position, compared to the instance where the payment was structured as an interest-free loan. In instances where case law does not exist, one can only rely on legislation and each individual's interpretation thereof, which could lead to inconsistent treatment of tax principles.

## 1.3 PURPOSE STATEMENT

The main purpose of this study is to establish, based on sound interpretations, whether or not the new funding structure of the employee share plan is beneficial to all relevant parties involved. The following main aspects will be taken into consideration when a critical analysis of the scheme will be performed:

- whether the fee and risk premium would be deductible from the holding companies' taxable earnings in terms of the Income Tax Act 58 of 1962 (hereafter "the Act"); and
- whether the wholly-owned subsidiary is entitled to any deductions in terms of the Act.

## 1.4 RESEARCH OBJECTIVES

The study aims to achieve a number of specific objectives:

- to determine if the fee and risk premium payable to the wholly-owned subsidiary would be tax deductible for the holding company in terms of Section 11 (a) of the Act;
- to determine whether section 23H of the Act will be applicable to any income tax deduction claimed by the holding company, and if so, whether the deduction will

effectively become available to the holding company over the vesting period or only at vesting;

- to determine whether or not the costs incurred by the subsidiary to acquire the holding company shares in the open market will be tax deductible; and
- to determine whether the future expenditure allowance in terms of section 24C of the Act will be available to the wholly-owned subsidiary.

## 1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY



Because any business will want to place itself and its employees in the best possible tax position, many schemes and structures have arisen to do so. It is therefore important to investigate and analyse these schemes and structures, evaluate the adequacy thereof, determine the legality of such a scheme or structure and establish if appropriate tax principles were applied to achieve such position.

Source: Cameron, 2011.

This study will aim to help fill the gap in relevant research, case law and legislation regarding the following tax implications:

- the deductibility, for the holding company, of the payment made to the subsidiary to acquire shares and to manage the employee share plan; and
- the deductibility, for the subsidiary, of the expenses incurred to acquire the shares against their taxable income, which is the payment received from the holding company.

## **1.6 DELIMITATIONS AND ASSUMPTIONS**

### **1.6.1 Delimitations**

The proposed study is focused on the income tax implications of the wholly-owned subsidiary and the holding company. The study will therefore not be considering the income tax implications for the individual employees to whom the conditional shares are distributed.

The study is further limited to the income tax implications. Stamp duties, deferred tax and VAT implications that may arise from this arrangement will not be considered.

Section 80A to 80L of the Act, which are applicable to impermissible tax avoidance agreements entered into purely to obtain a tax benefit, will not form part of the research proposal.

### **1.6.2 Assumptions**

The proposed study and comprehensive literature review is based on the following assumptions:

- that the holding company and the subsidiary company have the same tax year-end;
- that the conditional employee share plan does not contravene any provisions of the Companies Act;
- the holding company is not averse to the subsidiary company generating taxable income from the share plan;
- the subsidiary may not cede, transfer, dispose or deal with the holding company shares in any way, except for purposes of implementing the share plan. All surplus shares, after vesting in employees took place, will therefore be applied to future share transactions and will not be sold in the open market for gain by the subsidiary; and
- both the holding company and the subsidiary's place of effective management are inside the Republic of South Africa.

## 1.7 DEFINITION OF KEY TERMS

The key terms for the purpose of this study are defined below:

**Capital nature expenditure:** “An expenditure that will create an ending benefit for more than one year. It can increase the quantity or quality of services to be gained from the asset. It is charged to an asset account” (BizSuccess.Kudzu.com, n.d.).

**Conditional employee share plan:** “A plan to give, or encourage employees to buy, a stake in the company that employs them by awarding free or discounted shares” (QFinance, n.d.).

**Constructive obligation:** “Is an obligation that arrives from the entity’s actions which arises as a result of patterns in past practice that have indicated to other parties that the entity will accept certain responsibilities and as a result, the entity has created a valid expectation that the entity will discharge those responsibilities” (IAS 37, 2009).

**Disposal:** “An event, act, forbearance or operation of law, and “dispose” must be construed accordingly” (Paragraph 1 of the Eighth Schedule of the Act). According to The Free Online Dictionary a disposal would include the transference by gift or sale (TheFreeDictionary.com. n.d.).

**Future expenditure:** “In relation to any year of assessment, means an amount of expenditure which the Commissioner is satisfied will be incurred after the end of such year:

- in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment, or
- in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act” (Section 24C of the Act).

**Gross income:** “In the case of a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within



the Republic, during such a year or period of assessment, excluding receipts or accruals of a capital nature” (Section 1 of the Act).

**Income tax:** Income tax is a direct tax levied on a person’s income from various sources.

**Shares:** Ordinary shares are the issued share capital of the holding company.

**Share-based payment transaction:** “A transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or options), or acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of the entity’s shares or other equity instruments of the entity” (IFRS2 – Appendix A, 2009).

**Trading Stock:** “Includes anything:

- purchased or in any other manner acquired by a taxpayer for the sale or exchange by him or on his behalf, or
- the proceeds from the disposal of which forms or will form part of his gross income, otherwise than in terms of paragraph (j) or (m) of the definition of gross income” (Section 1 of the Act).

**Unconditional obligation:** Where an entity or person has no other realistic alternative, but to adhere to its obligations, without limitations, mitigating conditions or any reservations. An obligation can consist either of a legal obligation or a constructive obligation (IAS 37, 2009).

**Vest:** “To become an entitlement. Under a share-based payment arrangement, a counterparty’s right to receive cash, other assets, or equity instruments of the entity vests upon satisfaction of any specified vesting conditions” (IFRS2 – Appendix A, 2009).

**Vesting conditions:** “The conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions include service conditions, which require the other party to complete a specified period of service, and performance conditions,

which require specified performance targets to be met (such as a specified increase in the entity’s profit over a specified period of time)” (IFRS2 – Appendix A, 2009).

**Vesting period:** “The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied” (IFRS2 – Appendix A, 2009).

## 1.8 ABBREVIATIONS

**Table 1: Abbreviations used in this document**

The following recognised abbreviations are used in the research proposal:

<b>Abbreviation</b>	<b>Meaning</b>
Email	Electronic mail
FSB	Financial Services Board
IAS	International Accounting Standard, issued and published by the IASB
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Interpretations Committee, a committee of the IASB
PAYE	Pay As You Earn
Share plan	Employee share plan
STC	Secondary Tax on Companies
Subsidiary	Wholly-owned subsidiary
The Board	The Board of directors of the holding company
The Act	Income Tax Act No.58 of 1962

## 1.9 RESEARCH DESIGN AND METHODS

### 1.9.1 A description of the proposed study’s strategy of inquiry

Because any employer will want to place himself and his business in the best possible tax position, many schemes and structures have come to light to do so. A study on the investigation and evaluation of the adequacy and legality of such schemes and structures and whether or not appropriate tax principles were applied to achieve possible tax benefits, creates several research challenges. Limited or no previous research and

existing court cases will be readily available to guide the study on new schemes and structures that were recently implemented.

Given the inherent limitations faced when investigating and evaluating the adequacy and legality of any new scheme or structure, a qualitative strategy of inquiry will be followed to guide this study.

Information to establish the theoretical basis for this study will be obtained through a comprehensive literature review together with the performance of content and textual analysis of secondary data.

### **1.9.2 Data collection**

Relevant legislation, interpretation notes and court cases governing the income tax implications of interest-free loans as well as the new funding structure of employee share plans, will be selected based on the theoretical content of the relevant text or document.

## **1.10 CONCLUSION**

An introduction to past funding practices of conditional employee share plans through interest-free loans will be written in Chapter 2.

Second, an introduction will be written to the new funding structure of conditional employee share plans, where the payment is structured as a fee together with a risk premium, rather than an interest-free loan in Chapter 3.

Third, the income tax implications for the holding company and the subsidiary of past practices, namely financing the conditional employee share plan through an interest-free loan, will be analysed in Chapter 4.

Fourth, each of the possible tax benefits under the new financing structure will be analysed in detail in Chapter 5 to determine if the holding company and the subsidiary are entitled by law to the relevant tax deductions. Through this detailed analysis of the possible tax

benefits for the holding company and the subsidiary company, one can determine whether or not the scheme is beneficial to both parties involved.

Finally, Chapter 6 aims to provide a high-level comparison between the two funding possibilities, together with an overall conclusion which will address the purpose statement and research objectives of this study. Recent developments and the impact of conditional employee share schemes going forward will also be considered.

## **CHAPTER 2: AN INTRODUCTION TO PAST FUNDING PRACTICES OF CONDITIONAL EMPLOYEE SHARE PLANS**

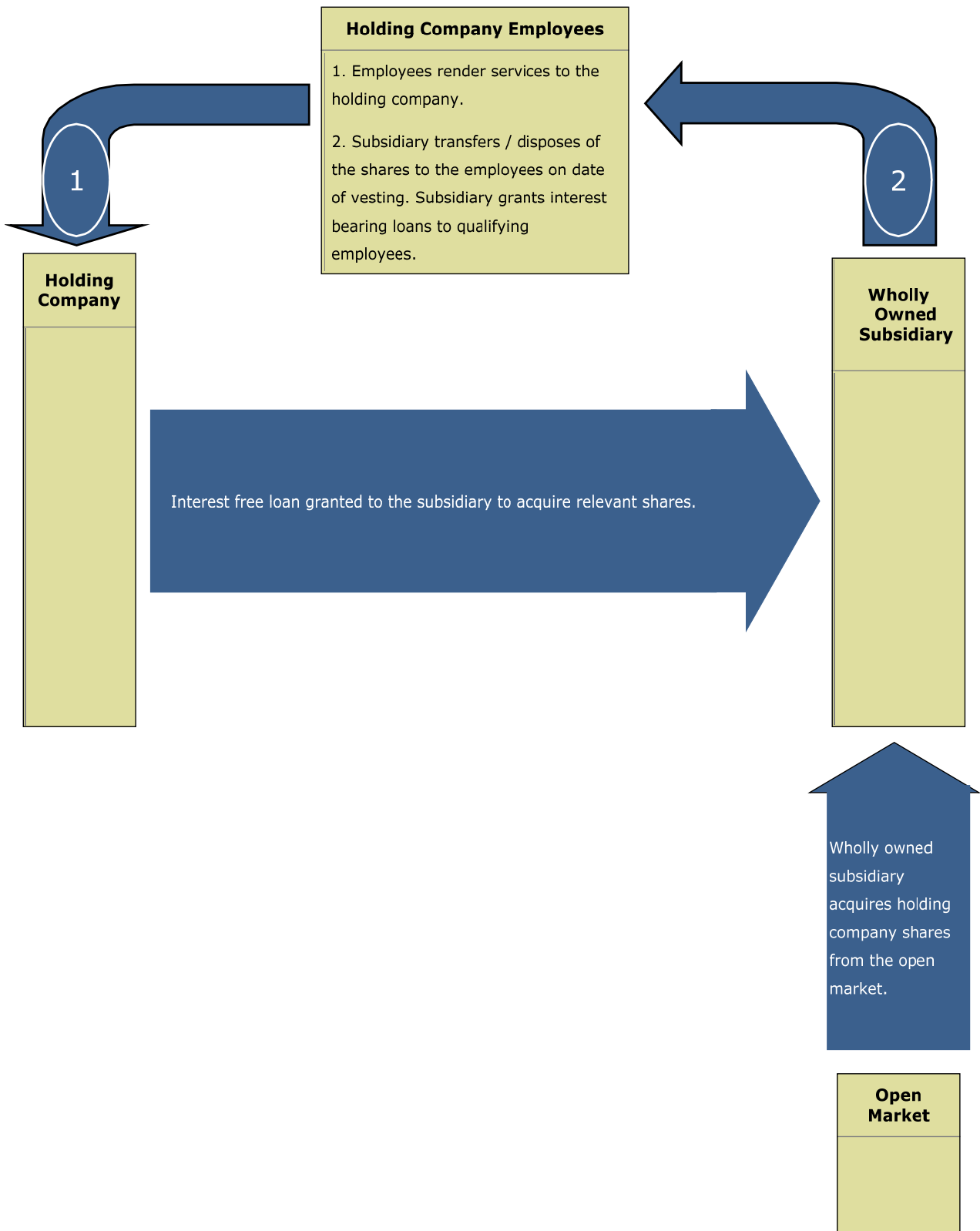
### **2.1 INTRODUCTION**

As established in Chapter 1, there are two possible funding schemes for conditional employee share plans, namely past practices, through funding the conditional employee share plan through an interest-free loan and current practices, where the funding is structured as a fee together with a risk premium.

In this chapter background information on past funding practices of conditional employee share plans will be discussed. This will enable one to form a better understanding of past practices and to have a basis of comparison on which to assess future schemes and the possible benefits they might entail. The funding structure and flow of transactions of the conditional employee share plan are demonstrated in Figure 1 below.

### **2.2 STRUCTURE OF THE CONDITIONAL EMPLOYEE SHARE PLANS DURING PAST PRACTICES**

**Figure 1: Funding structure and flow of transactions of the conditional employee share plan during past practices.**



A company would implement a conditional employee share plan as an incentive to employees giving long and continuous service as well as to compensate the employees for their commitment in reaching company goals and performance criteria.

The company would then incorporate a wholly-owned subsidiary to administer the employee share plan on behalf of the holding company. This would include acquiring holding company shares in the open market and the subsequent transfer / disposal thereof to the holding company's employees.

The holding company would grant an interest-free loan to the subsidiary to enable the subsidiary to acquire holding company shares in the open market at market value.

The subsidiary would in turn then grant interest-bearing loans to the qualifying holding company employees to finance the acquisition of their allocated offer of holding company shares. The subsidiary would keep a separate loan account for each qualifying employee, which will reflect the liability of that qualifying employee to the subsidiary, which would be the purchase price of the allocated shares.

The subsidiary shall have all voting rights in respect of the offer shares which are not fully paid for prior to the transfer of the offer shares to the qualifying employees. After the loan is repaid, the offer shares will be transferred to the relevant employees.

Therefore, the subsidiary holds the shares for its own risk and reward, regardless of the timeframe. The subsidiary holds the shares, from the time the subsidiary acquired the holding company shares in the open market until the subsequent transfer / disposal of the shares to the holding company employees. Therefore the risks and rewards of the sale transaction were transferred to the subsidiary and the subsidiary therefore does not hold the shares on behalf of the holding company or the employees of the holding company.

## **2.3 CONCLUSION**



Background information relating to past funding practices were discussed in Chapter 2, to enable one to form a better understanding of past practices and to create a basis of comparison to assess future schemes and the possible benefits it might entail.

In Chapter 3, the new funding structure of conditional employee share plans, where the payment is structured as a fee together with a risk premium, rather than an interest-free loan, is discussed.

## **CHAPTER 3: AN INTRODUCTION TO THE NEW FUNDING STRUCTURE OF CONDITIONAL EMPLOYEE SHARE PLANS**

### **3.1 INTRODUCTION**

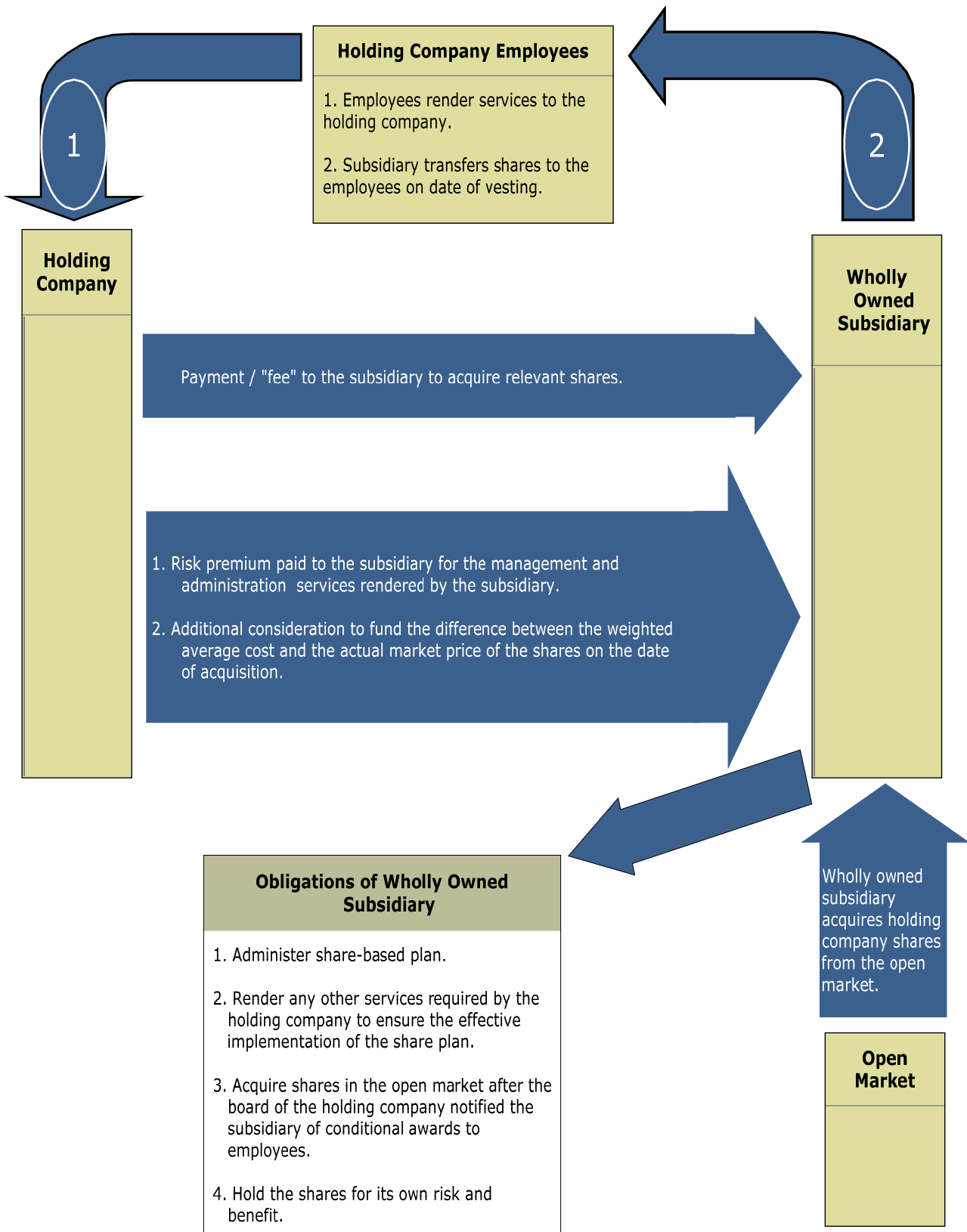
It was established in Chapter 1 that two possible funding structures exist for conditional employee share plans, namely past practices, through funding the conditional employee share plan through an interest-free loan and current practices, where the funding is structured as a fee together with a risk premium.

In the previous chapter, background information relating to past practices were discussed, enabling one to form a better understanding of past practices and to create a basis of comparison to assess future schemes and the possible benefits they might entail.

This chapter serves as an introduction to the new funding structure for conditional employee share plans. This will enable one to form a better understanding of current practices and the possible benefits it might entail. The new funding structure and flow of transactions of the conditional employee share plan is demonstrated in Figure 2 below:

### **3.2 NEW FUNDING STRUCTURE OF THE CONDITIONAL EMPLOYEE SHARE PLAN**

**Figure 2: New funding structure and flow of transactions of the conditional employee share plan.**



A company would implement a conditional employee share plan, as an incentive to employees serving long and continuous service as well as to compensate the employees for their commitment in reaching company goals and performance criteria.

The company would then incorporate a wholly-owned subsidiary to administer and manage the conditional employee share plan on behalf of the holding company. This would include acquiring holding company shares in the open market and the subsequent transfer thereof to the holding company's employees. The holding company would in return for these services rendered, pay a fee together with a risk premium to the subsidiary.

The services to be rendered and the fees payable will typically be agreed through the signing of a service level agreement by both parties. The service level agreement will contain the payment terms, scope of the services to be rendered, limitations and conditions of the agreement between the two parties.

The fee paid to the subsidiary would enable the subsidiary to acquire holding company shares in the open market. This fee is based on the weighted average cost of the shares during the time of the Board approval of the conditional awards to employees.

The risk premium paid to the subsidiary serves a dual purpose, namely:

- as additional consideration to compensate the subsidiary for any possible differences between the weighted average cost of the shares as calculated by the Board of the holding company during the time the decision was made to acquire holding company shares and the actual market price of the shares on the date of the acquisition; and
- as consideration for the management and administration services rendered by the subsidiary.

The risk premium only covers possible price fluctuations or possible losses between the period the Board calculated the weighted average cost of the shares, which will be upon their decision to acquire shares, and the time the subsidiary actually acquires the holding company shares in the open market.

The subsidiary holds the shares for its own risk and reward, from the time the subsidiary acquired the holding company shares in the open market until the subsequent transfer of the shares to the holding company employees. Therefore the risks and rewards of the sale transaction were transferred to the subsidiary and the subsidiary therefore does not hold the shares on behalf of the holding company or the employees of the holding company.

### **3.3 POSSIBLE TAX BENEFITS OF THE NEW FUNDING STRUCTURE**

In summary the above scheme will attempt to accomplish the following tax benefits:

- a tax deduction, for the holding company, for the payment made to the subsidiary to acquire shares and to manage the employee share plan;
- a tax deduction, for the subsidiary company, for the expenses incurred to acquire the shares against its taxable income, which is the payment received from the holding company; and
- the administration charge to result in a zero tax effect for the group, due to the holding company receiving a tax deduction for the administration charges paid to the subsidiary and the amount received by the subsidiary to be included in its gross income and therefore taxable.

### **3.4 CONCLUSION**

Chapter 3 served as an introduction to the new funding structure of conditional employee share plans to enable one to form a better understanding of current practices and the possible benefits it might entail.

In Chapter 4 the income tax implications, for the holding company and the subsidiary, of past practices being the financing of the conditional employee share plan through an interest-free loan will be analysed.

A detailed analysis of each of the above possible tax benefits under the new financing structure will be undertaken in Chapter 5, to determine if the holding company and the

subsidiary is entitled, by law, to the relevant tax deductions. Through this detailed analysis of the possible tax benefits of the holding company and the subsidiary company, one can determine whether or not the scheme is beneficial to both parties involved.

## **CHAPTER 4: AN ANALYSIS OF THE INCOME TAX IMPLICATIONS OF PAST PRACTICES**

### **4.1 INTRODUCTION**

Background information relating to past funding practices and the flow of transactions were provided in Chapter 2.

This chapter provides a contextual understanding of the income tax implications of past practices, namely financing conditional employee share plans through an interest-free loan, for the holding company and the wholly-owned subsidiary. Based on past practices, one also needs to consider the income tax implication of the subsidiary, upon transfer or disposal of the holding company shares to qualifying holding company employees. This was commonly financed through a loan granted by the subsidiary, to the qualifying holding company employees, based on similar vesting conditions, as previously discussed. The continued discussion revolves primarily around the analysis of relevant interpretation notes, case law and the Act, of the above scheme, in relation to taxpayers in South Africa.

### **4.2 TAX IMPLICATIONS FOR THE HOLDING COMPANY IN TERMS OF PAST PRACTICES**

This section refers to the income tax implications for the holding company with regards to the payment, structured as an interest-free loan, to finance the acquisition of the holding company shares in the open market.

#### **4.2.1 The general deduction formula: Section 11 (a)**

To determine the deductibility of the payment made by the holding company, one has to consider the relevant legislation. The deductibility of expenses should be determined by using specific sections within the Act specifically and then the general deduction formula.

As mentioned before, this issue is not specifically covered by legislation and therefore the deductibility should be evaluated through the use of the general deduction formula – (Section 11 (a)).

Section 11 (a) of the Act states that: “For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature”.

#### **4.2.2 Section 23g of the Act**

Section 23 (g) of the Act states that: “No deductions shall in any case be made in respect of the following matters, namely, any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade”.

#### **4.2.3 Analysis of section 11a and 23g of the Act**

The loan capital payable by the holding company to the subsidiary will only be deductible from the holding company’s gross income if it meets the requirements as set out in section 11 (a) together with section 23 (g) of the Act, namely that it was:

- Expenditure
- Actually incurred
- In the production of income
- Not of a capital nature
- Expended for the purpose of trade

The payment of the loan amount by the holding company, constitutes an **expense** to the holding company, because the holding company granted an interest-free loan to the subsidiary, for the services to be rendered by the subsidiary. The cash outflow will therefore result in an expense to the holding company.



The service level agreement between the holding company and the subsidiary places an unconditional obligation on the holding company to grant the loan to the subsidiary in order to acquire holding company shares in the open market. Based on the fact that an unconditional liability exists (**CIR v Edgar Stores Ltd**, 1986 (4) SA 312 (T) (48 SATC 89)), the payment / expenditure will also be regarded as having been “**actually incurred**” for income tax purposes regardless of whether the liability has been discharged or not (**Caltex Oil (SA) Ltd v SIR**, 1975 (1) SA 665 (A) (37 SATC 1)).

To determine whether or not the payment or expense is in fact **in the production of income**, one must consider both of the following two questions as ruled in the **Port Elizabeth Electric Tramway Co. Ltd. v CIR**, 1936 CPD 241 (8 SATC 13) court case:

- Whether the purpose of the act, to which the expenditure is attached, is to produce income?
- Whether the expenditure is linked closely to this act?

The court held that all expenses incurred for the purpose of earning income are deductible, whether such expenses are necessary for the performance of their business operations, attached to it by chance or incurred to enhance the efficiency of business operations, provided that the expenses are so closely linked to the operations, that it would be regarded as an integral part of the operational cost.

Firstly, one needs to consider whether the purpose of the act, the productiveness and effectiveness of employees, is to produce income. The Court in **Provider v COT**, 1950 (4) SA 289 (SR) (17 SATC 40) considered two incentive schemes and found on the facts that such schemes are:

- designed to secure a contented staff, giving long and continuous service with the benefits to production which must follow such conditions; and
- closely analogous to the annual bonuses and the other deferred emoluments which are clearly deductible for income tax purposes.

Based on the above findings the share plan is clearly designed with the aim to secure a contented staff complement for the holding company employees, giving long and continuous service which will result in an increase in income of the holding company. This is demonstrated through the fact that employees have to comply with the vesting conditions, which also include certain performance criteria. The purpose of the act will therefore be in the production of income.

Secondly, one needs to consider whether the expense is closely linked to the above act. Therefore, whether or not, the payment of the loan amount is closely related to the holding company's income producing activities, being the productiveness and effectiveness of the holding company's employees, which in turn would give rise to continued growth of the holding company.

The share plan is based on conditional shares. The employees will receive a conditional amount of shares based on whether or not or the extent to which such an employee met the vesting conditions. Therefore, it must be determined whether the qualifying employee meets the vesting conditions of the scheme. These vesting conditions include, whether the employee is still in employment of the holding company at the specified future date, and have met the specified performance criteria.

The sole purpose of the interest-free loan amount, granted to the subsidiary, is to finance the acquisition of holding company shares in the open market. Therefore the payment is closely linked to the above act and could be regarded as incurred in the production of income for the holding company.

Lastly, one needs to consider whether the loan amount is closely related to the holding company's **income producing operations** rather than its income earning structure (**CIR v George Forest Timber Co Ltd**, 1924 AD 516 (1 SATC 20)). As the holding company does not grant loans to third parties in its ordinary course of business, one cannot satisfactorily show that loan amounts granted, are custom to the holding company's trade and forms an integral part of the business. The holding company would therefore, not be considered as conducting a money-lending business. Loan amounts granted as a finance

structure would be regarded as capital of nature (**Stone v SIR**, 1974 (3) SA 584 (A) (36 SATC 117)).

The court furthermore held that, loan amounts granted in circumstances other than in the ordinary course of business, would constitute fixed capital and not capital of a floating / circulating nature and would therefore be regarded as an expense of a **capital nature**.

#### **4.2.4 Conclusion for the holding company**

Since the holding company does not grant loans in its ordinary course of business, the loan amount payable will not be expended for the purpose of carrying on a trade and would therefore represent a capital expenditure that will not be deductible in terms of the requirements of section 11(a) and section 23 (g) of the Act.

Furthermore, losses suffered on irrecoverable loans will also not be deductible by the holding company, if the loan becomes irrecoverable at any stage, as the losses would not have been incurred in the ordinary course of business and would therefore also be regarded as a capital expenditure.

### **4.3 TAX IMPLICATIONS FOR THE WHOLLY-OWNED SUBSIDIARY IN TERMS OF PAST PRACTICES**

This section refers to the tax implications for the subsidiary:

- for the **payments received** from the holding company, structured as an interest-free loan, for the sole purpose of acquiring holding company shares in the open market; and
- for loan **payments made** to qualifying employees, to finance the acquisition of holding company shares.

#### **4.3.1 Payments received**

#### 4.3.1.1 Gross income

“Gross income in relation to any year or period of assessment means, in the case of a resident of South Africa, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described in paragraphs (a) to (n) of the definition of gross income” (Section 1 of the Act).

#### 4.3.1.2 Relevant case law and interpretation notes

- **CIR v Genn and Co (Pty) Ltd**

Briefly, the facts of the **CIR v Genn and Co (Pty) Ltd**, 1955 (3) SA 293 (A) (20 SATC 113) case, the taxpayer, a hardware and timber merchant, purchased trading stock, in its ordinary course of business, from local and international suppliers. In order for the company to make use of quantity- and cash- discounts granted by the suppliers, the company entered into an interest-bearing loan agreement, which enabled them to order large quantities and to make upfront payments to the suppliers for goods delivered (**CIR v Genn & Co (Pty) Ltd**, 1955 (3) SA 293 (A) (20 SATC 113)).

- **SARS v Brummeria Renaissance (Pty) Ltd and Others**

Briefly, the facts of the Brummeria case are that the taxpayers, a number of development companies, had developed retirement villages. In terms of their business operation potential residents would grant the companies interest-free loans in advance. In turn these residents would be granted the lifelong right to the occupancy of a certain unit for no rental consideration. The interest-free loan would be used by the development company to finance the construction costs of the unit. On cancellation by, or death of, the occupant, the interest-free loan would be repaid out of proceeds of a new loan, when a new occupant advanced a further loan to the company (**CSARS v Brummeria Renaissance (Pty) Ltd and Others**, 2007 (SCA) (69 SATC 201)).

- **Brummeria Interpretation Note**

According to the Brummeria Interpretation Note (2008), (the “Interpretation Note”), “the judgment in the Brummeria case may be referred to an authority for the following principles:

- the right to use the loan capital interest-free has a monetary value;
- even though the receipt or accrual of the right is in a form other than money, and cannot be alienated or converted into money, it does not mean that the receipt of the right has no monetary value. The test to be applied in order to determine whether the receipt or accrual has a monetary value is an objective and not a subjective test;
- the value of the receipt or accrual in a form other than money (*in casu*, the right to use an interest-free loan) constitutes an “amount” that “accrues” to the taxpayer. This “amount” or “accrual” should be included in the gross income of the taxpayer in the year of assessment for which the right is received by, or accrued to, the taxpayer. Also confirmed is the fact that the word “amount” in the definition of gross income is to be interpreted widely;
- for a benefit of this nature to be taxable it is not necessary to fall within the provisions of paragraph (i) of the definition of “gross income” in the Act.”

#### **4.3.1.3 Analysis of relevant case law, interpretation notes and legislation**

In **CIR v Genn and Co (Pty) Ltd**, 1955 (3) SA 293 (A) (20 SATC 113), the court held that obtaining physical control over money or money’s worth, does not always constitute a receipt for the purposes of the definition of gross income of section 1 of the Act. Loan amounts are not always received within the meaning of the definition of gross income. This is because the borrower, in this instance the subsidiary company, falls under the obligation to repay the loan amount at the very same moment that the borrower obtained possession or physical control over the loan amount.

After the judgement was handed down by the Supreme Court of Appeal in **CSARS v Brummeria Renaissance (Pty) Ltd and Others**, 2007 (SCA) (69 SATC 201), the generally accepted non-taxable consequence of interest-free loans has come to an end.

Based on the Interpretation Note, the Supreme Court of Appeal held that the right to use loan capital interest-free had an ascertainable money value that should be included in the gross income of the taxpayer.

One should note that the Supreme Court of Appeal ruled that the right to retain and use the borrowed funds without paying any interest, and not the receipt of the loan capital as such, represents “an amount” which should be included in gross income. According to Cloete JA, the judge delivering the unanimous decision of the Supreme Court of Appeal, “the right to retain and use the loan capital interest-free for a period of time is a valuable right, which is capable of being valued in money” (De Koker, 2009).

“The inclusion of this amount in the gross income of the taxpayer is in much the same way as an employee would be taxed on a fringe benefit, where the employer had granted the employee an interest-free loan” (De Koker, 2009).

The judgement will not apply in all instances of interest-free loans. This will typically be the case in instances where interest-free loans are made between companies within the same group of companies granted in a capital context. The judgement will therefore not apply in instances where the right to use an interest-free loan was made either with the intention of providing long-term working capital to the company or to meet capital expenditure requirements within the same group of companies. The intension of the companies is therefore an important factor to take into consideration when applying the principles of the Brummeria case.

“The ruling will however be applied in all cases where benefits in a form other than money (such as the right to an interest-free loan) are granted in exchange (or as a *quid pro quo*) for goods supplied, services rendered or any other benefit given” (Brummeria Interpretation Note, 2008:1).

The value of the receipt or accrual in the form other than money should therefore be determined and be included in the gross income of the taxpayer. According to the Interpretation Note the valuation test is of an objective nature and one should apply arm's length principles together, with due regard to the facts and circumstances of the case and the intentions of the parties.

#### **4.3.1.4 Connected parties**

Due to the fact that the subsidiary is wholly-owned, the companies would form part of the same group of companies and would in turn be regarded as connected parties.

According to section 31 of the Act, where any goods or services were effected between parties who are connected persons in relation to each other at a price which is either more or less than the expected arm's length price for the goods or services, the Commissioner has the right to adjust the price to reflect an arm's length price for the goods or services.

The amount included in gross income should not be the entire amount of the interest-free loan, but rather the notional amount of interest that would otherwise have accrued on the loan.

#### **4.3.1.5 Analysis of section 31 of the Act**

If the structure was funded through an interest-free loan, this loan would not have been granted in a capital context and would therefore have tax implications to the subsidiary.

The holding company would have granted the loan to the subsidiary in exchange for services rendered by the subsidiary company to the holding company. These services include the acquisition of holding company shares in the open market, which will subsequently be transferred to the employees of the holding company as a contented staff complement for giving long and continuous service.

#### 4.3.2 Payments made

The **expenses incurred by the subsidiary to acquire holding company shares** in the open market as well as any **subsequent expenses incurred, through loans granted to qualifying employees**, to finance the acquisition of holding company shares, will only be deductible for income tax purposes if they meet the requirements as set out in section 11 (a) together with section 23 (g) of the Act. The requirements are that the expenses should be:

- Expenditure
- Actually incurred
- In the production of income
- Not of a capital nature
- Expended for the purpose of trade.

The payment made by the subsidiary to acquire the shares and to finance the acquisition by qualifying employees, constitutes an **expense** to the subsidiary as there was an actual outflow of cash from the subsidiary to the open market.

The service-level agreement between the holding company and the subsidiary places an unconditional obligation on the subsidiary to acquire holding company shares in the open market when the Board decides, authorises and informs the subsidiary of such decision. The service-level agreement also places an unconditional obligation on the subsidiary to transfer or dispose of such shares to qualifying employees, at a future date, upon vesting. Based on the fact that an unconditional liability exists (**CIR v Edgar Stores Ltd**, 1986 (4) SA 312 (T) (48 SATC 89)), the payments will also be regarded as having been “**actually incurred**” for income tax purposes regardless of whether the liability has been discharged or not (**Caltex Oil (SA) Ltd v SIR**, 1975 (1) SA 665 (A) (37 SATC 1)).

To determine whether or not the payment or expense is in fact **in the production of income**, one must consider both of the following two questions as ruled in the **Port Elizabeth Electric Tramway Co. Ltd. v CIR**, 1936 CPD 241 (8 SATC 13) court case:



- Whether the purpose of the act, to which the expenditure is attached, is to produce income?
- Whether the expenditure is linked closely to this act?

Firstly, one needs to consider whether the purpose of the act, the rendering of services, being the acquisition of holding company shares in the open market and the subsequent transfer thereof to qualifying holding company employees, is to produce income.

The subsidiary is incorporated for the sole purpose of administering the holding company's employee share plan. The duties and obligations of the subsidiary as set out in the service-level agreement between the holding company and the subsidiary is to administer the employee share plan, which includes the acquisition of holding company shares and transferring them to the employees upon vesting. In return for these services being rendered the subsidiary will receive an interest-free loan from the holding company as compensation for the services rendered by the subsidiary.

The interest-free loan will not result in an increase in income for the subsidiary as the interest-free loan will not constitute income for the subsidiary based on the fact that the loan amount will remain of a capital nature and the only amount included in the subsidiary's gross income will be the deemed or notional amount of interest by virtue of the judgement passed in the Brummeria case.

Therefore, the rendering of services by the subsidiary, as defined above, is not an income-producing activity that will attract income, which will be included in the gross income of the subsidiary company.

Due to the fact that the above act does not form part of the subsidiary's income-producing activities, the second question, namely whether the expenditure is closely linked to the income-producing act, does not need to be addressed.

As discussed, the expense incurred to acquire holding company shares as well as any subsequent expenses incurred, through loans granted to qualifying employees, to finance the acquisition of holding company shares, does not form part of the subsidiary's **income-producing operations (CIR v George Forest Timber Co Ltd, 1924 AD 516 (1 SATC**

20)). This further supports the argument that the expense forms part of the subsidiary's income earning structure rather than its income producing operations. The expenses incurred were therefore not for purposes of the subsidiary company's **trade** and would therefore **be of a capital nature**.

Furthermore, due to the fact that the subsidiary company does not grant loans to third parties in its ordinary course of business, one cannot satisfactorily show that loan amounts granted, are customary to the subsidiary company's trade and forms an integral part of the business. The subsidiary company would therefore not be considered as conducting a money-lending business. Loan amounts granted as a finance structure would be regarded as capital of nature (**Stone v SIR**, 1974 (3) SA 584 (A) (36 SATC 117)).

The court furthermore held that, loan amounts granted in circumstances other than in the ordinary course of business, would constitute fixed capital and not capital of a floating / circulating nature and would therefore be regarded as an expense of **a capital nature**.

#### **4.3.3 Conclusion for the subsidiary**

The capital amount advanced to the subsidiary company, by the holding company, in the form of an interest-free loan, would not be included in the subsidiary's gross income, because the loan amount does not constitute a receipt as defined in the definition of gross income in section 1 of the Act.

The notional amount of interest would be included in the subsidiary's gross income at the effective interest rate or the rate applicable in an arm's length transaction between two independent parties.

The costs incurred by the subsidiary to acquire the holding company's shares in the open market would not be deductible as it is not in the production of income and was not expended for purposes of trade.

Any subsequent costs incurred by the subsidiary to transfer or dispose of the shares in the holding company to qualified holding company employees would not be deductible as it is not in the production of income and was not expended for purposes of trade.

Due to the fact that the subsidiary company does not grant loans in its ordinary course of business, the loan amount payable will not be expended for the purpose of carrying on a trade and would therefore represent a capital expenditure that will not be deductible in terms of the requirements of section 11(a) and section 23 (g) of the Act.

#### **4.4 CONCLUSION**

A contextual understanding of the income tax implications of past funding practices, namely financing conditional employee share plans through an interest-free loan, have been discussed for the holding company and the wholly-owned subsidiary.

A conclusion has been reached in terms of past funding practices, resulting in no deduction or tax benefit for the holding company and the taxability of the notional amount of interest for the wholly-owned subsidiary.

Detailed analyses of each of the above possible tax benefits under the new financing structure will be undertaken in Chapter 5, to determine if the holding company and the subsidiary are entitled, by law, to the relevant tax deductions. Through this detailed analysis of the possible tax benefits of the holding company and the subsidiary company, one can determine whether or not the scheme is beneficial to both parties involved.

## **CHAPTER 5: AN ANALYSIS OF THE INCOME TAX IMPLICATIONS OF THE NEW FUNDING STRUCTURE**

### **5.1 INTRODUCTION**

An introduction to the new funding structure and the flow of transactions has been discussed in Chapter 4.

This chapter provides a contextual understanding of the income tax implications of the new funding structure, where the payment to the subsidiary is structured as a fee together with a risk premium, rather than an interest-free loan, for the holding company and the wholly-owned subsidiary. This discussion revolves primarily around the analysis of relevant interpretation notes, case law and the Act, of the above scheme, in relation to taxpayers in South Africa.

### **5.2 TAX IMPLICATIONS FOR THE HOLDING COMPANY IN TERMS OF THE NEW FUNDING STRUCTURE**

This section refers to the tax implications for the holding company with regard to the payment made to the subsidiary to acquire shares and to manage the employee share plan.

#### **5.2.1 The general deduction formula: Section 11 (a)**

To determine the deductibility of the payment made by the holding company, one has to consider the relevant legislation. The deductibility of expenses should be determined by using specific sections within the Act and then the general deduction formula. As mentioned before, this issue is not specifically covered by legislation, namely the Act, and therefore the deductibility should be evaluated through the use of the general deduction formula.

## 5.2.2 Analysis of section 11a and 23g of the Act

The fee and risk premium payable by the holding company to the subsidiary will only be deductible from the holding company's gross income if it meets the requirements as set out in section 11 (a) together with section 23 (g) of the Act. The fee and risk premium should be:

- Expenditure
- Actually incurred
- In the production of income
- Not of a capital nature
- Expended for the purpose of trade

The payment made by the holding company, constitutes an **expense** to the holding company, due to the fact that the holding company paid the subsidiary the fee together with a risk premium for the services to be rendered by the subsidiary.

The service-level agreement between the holding company and the subsidiary places an unconditional obligation on the holding company to pay the fee and risk premium to the subsidiary. Based on the fact that an unconditional liability exists (**CIR v Edgar Stores Ltd**, 1986 (4) SA 312 (T) (48 SATC 89)), the fee will also be regarded as having been “**actually incurred**” for income tax purposes regardless of whether the liability has been discharged or not (**Caltex Oil (SA) Ltd v SIR**, 1975 (1) SA 665 (A) (37 SATC 1)).

To determine whether or not the payment or expense is in fact **in the production of income**, one must consider both of the following two questions as ruled in the **Port Elizabeth Electric Tramway Co. Ltd. v CIR**, 1936 CPD 241 (8 SATC 13) court case:

- Whether the purpose of the act, to which the expenditure is attached, is to produce income?
- Whether the expenditure is linked closely to this act?

Firstly, one needs to consider whether the purpose of the act, the productiveness and effectiveness of employees, is to produce income. The Court in **Provider v COT**, 1950 (4) SA 289 (SR) (17 SATC 40) considered two incentive schemes and found on the facts that such schemes are:

- designed to secure a contented staff, giving long and continuous service with the benefits to production which must follow such conditions, and
- closely analogous to the annual bonuses and the other deferred emoluments which are clearly deductible for income tax purposes.

Based on the findings above the share plan is clearly designed with the aim to secure a contented staff complement for the holding company employees, giving long and continuous service which will result in an increase in income for the holding company. This is demonstrated through the fact that employees have to comply with the vesting conditions, which also includes certain performance criteria. The purpose of the expense will therefore be in the production of income.

Secondly, one needs to consider whether the expense is closely linked to the above act. Therefore, whether or not, the payment of the fee and the risk premium is closely related to the holding company's income-producing activities, these being dependent on the productiveness and effectiveness of the holding company's employees.

The share plan is based on conditional shares. The employees will receive a conditional number of shares, based on whether or not or the extent to which such an employee met the vesting conditions. Therefore, it must be determined whether the qualifying employee meets the vesting conditions of the scheme. These vesting conditions include, whether the employee is still in the employment of the holding company at the specified future date, and has met the specified performance criteria.

The payment made to the subsidiary relates to the proper administration, management and implementation of the share plan. Therefore the payment is closely linked to the above act and it can therefore be concluded that the fee and risk premium, will be in the production of income for the holding company.

Lastly, the fee and the risk premium relates to the share plan, implemented to incentivise the employees of the holding company. The expense is therefore more closely related to the holding company's **income producing operations** than its income earning structure (**CIR v CIR v George Forest Timber Co Ltd**, 1924 AD 516 (1 SATC 20)). Further the expenditure will be on a recurring basis from time to time (when the Board meets to discuss the award of conditional shares to employees), which contribute to the fact that the expense is more closely related to the holding company's income producing activities.

As discussed above the fee and risk premium expense relates to the share plan, which is implemented to incentivise the employees of the holding company and one can therefore argue that it is incurred for the purpose of the holding company's **trade** and would therefore **not be of a capital nature**.

### 5.2.3 Section 23H of the Act

Section 23H applies to allowances and deductions dealt with under section 11 (a), (c) or (d) of the Act or section 28 (2) (a) and (c) of the Act.

In terms of section 23H the deduction of certain allowable expenditure will be deferred to a future date in respect of:

- goods or services where the goods or services will not be rendered to the taxpayer in the year of assessment in which it is incurred, and
- benefits, if the period to which the expenditure relates extends beyond such year of assessment.

Section 23H (1) limits the expenditure in a particular year of assessment as follows:

- In the case of goods to be supplied, so much of the expenditure that relates to goods actually supplied to the taxpayer in a particular year of assessment;
- In the case of services to be rendered, so much of the pro-rata amount of such expenditure as relates to the number of months during which such services are rendered in a particular tax year; and

- In the case of any other benefit, so much of the pro-rata amount of such expenditure as relates to the number of months in that particular year of assessment during which such benefit is enjoyed.

Provided that the provisions of this section shall not apply:

- where all the goods or services are to be supplied or rendered within six months after the end of the year of assessment during which the expenditure was incurred, or such person will have the full enjoyment of such benefit in respect of which the expenditure was incurred within such period, unless the expenditure is allowable as a deduction in terms of section 11D (1); or
- where the aggregate of all amounts of expenditure incurred by such person, which would otherwise be limited by this section, does not exceed R80 000; or
- to any expenditure to which the provisions of section 24K or 24L apply; or
- to any expenditure actually paid in respect of any unconditional liability to pay an amount imposed by legislation.

#### **5.2.4 Analysis of section 23H of the Act**

As discussed in the previous section, the fee and the risk premium are deductible for the holding company in terms of section 11 (a) of the Act and therefore the provisions of Section 23H need to be taken into consideration.

A “benefit” in the context of section 23H of the Act includes insurance cover. The payment made to the subsidiary includes a risk premium, which serves a dual purpose of compensating the subsidiary for possible price fluctuations between the weighted average price as calculated by the Board and the actual share price paid by the subsidiary on acquisition of the shares. The other purpose of this payment is to compensate the subsidiary for the management and administration services rendered by them.

One therefore needs to consider whether the payment of the risk premium needs to be considered as a payment for other benefits or a payment for services to be rendered.



Although the subsidiary may bear some risk in supplying these services, the payment clearly does not refer to any insurance premiums and as such is not a payment for a “benefit” as contemplated by section 23H (1) (b) (ii). This payment is referred to as a risk premium, but does not constitute a risk premium in the actual meaning of the word, but rather a payment for the services to be rendered by the subsidiary.

The payment made by the holding company to the subsidiary will therefore be regarded as a payment for services to be rendered by the subsidiary as contemplated by section 23H (1) (b) (i).

The commencement and timing of services rendered by the subsidiary, need to be taken into consideration to determine the deferral of the deduction of the expenses incurred by the holding company.

Firstly, one needs to consider the payment made to the subsidiary to acquire holding company shares. In this instance the services rendered is a once-off service and will only commence as soon as the subsidiary acquires the shares, as agreed upon and authorised by the Board, in the open market. Therefore, if the subsidiary does not apply the fee and the risk premium to acquire holding company shares in the same year in which the expense was actually incurred by the holding company, the commencement of the services will only be in the subsequent year in which the shares are acquired and the deduction of the expense will be deferred to such date.

Secondly, the payment made to the subsidiary to manage and administer a specific share transaction within the share plan, needs to be taken into consideration. In this instance the services rendered will commence as soon as the subsidiary acquires the shares and will be discharged in full when the shares in respect of the specific share transaction are transferred to an employee.

### **5.2.5 Conclusion for the holding company**

All the above requirements of the general deduction formula, together with the limitation of section 23 (g) of the Act have been met. The fee and risk premium is therefore deductible, by the holding company, for South African income tax purposes.

The payment made to the subsidiary to acquire holding company shares will only be deductible by the holding company once the subsidiary applied the funds to acquire the shares in the open market. The payment made to the subsidiary to manage and administer a specific transaction within the share plan needs to be pro-rated over the vesting period of such shares, according to Section 23 H.

## **5.3 TAX IMPLICATIONS FOR THE WHOLLY-OWNED SUBSIDIARY IN TERMS OF THE NEW FUNDING STRUCTURE**

This section refers to the tax implications to the subsidiary for the payments received from the holding company to acquire shares and to manage the employee share plan, as well as the tax implications of the expense incurred to acquire holding company shares in the open market.

### **5.3.1 Payments received**

#### **5.3.1.1 Gross income**

“Gross income in relation to any year or period of assessment means, in the case of a resident of South Africa, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described in paragraphs (a) to (n) of the definition of gross income” (Section 1 of the Act).

In terms of paragraph (c) of the definition of gross income of the Act, any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered, or any amount received or accrued in respect of or by virtue of any employment or the holding of any office, is included in gross income.

### 5.3.1.2 Analysis of the gross income definition

The subsidiary is incorporated for the sole purpose of managing and administering the holding company's employee share plan and generates all its revenue through the rendering of these services. The scope of the services and fees receivable are set out in the service-level agreement between the holding company and the subsidiary company. Because the payments are received for rendering services they will not be of a capital nature.

Amounts received for services rendered are furthermore a specific inclusion in taxable income in terms of paragraph c of the gross income definition of section 1 of the Act.

### 5.3.2 Payments made

The expense incurred by the subsidiary to acquire holding company shares in the open market will only be deductible for income tax purposes if it meets the requirements as set out in section 11 (a) together with section 23 (g) of the Act. The expense should be:

- Expenditure
- Actually incurred
- In the production of income
- Not of a capital nature
- Expended for the purpose of trade

The payment made by the subsidiary, to acquire the shares, constitutes an **expense** to the subsidiary as there was an actual outflow of cash from the subsidiary to the open market.

The service-level agreement between the holding company and the subsidiary places an unconditional obligation on the subsidiary to acquire holding company shares in the open market when the Board decides, authorises and informs the subsidiary of such decision. Based on the fact that an unconditional liability exists (**CIR v Edgar Stores Ltd**, 1986 (4) SA 312 (T) (48 SATC 89)), the fee will also be regarded as having been “**actually incurred**” for income tax purposes regardless of whether the liability has been discharged or not (**Caltex Oil (SA) Ltd v SIR**, 1975 (1) SA 665 (A) (37 SATC 1)).

As discussed above, to determine whether or not the payment / expense is in fact **in the production of income**, one must consider both of the following two questions as ruled in the **Port Elizabeth Electric Tramway Co. Ltd. v CIR**, 1936 CPD 241 (8 SATC 13):

- Whether the purpose of the act, to which the expenditure is attached, is to produce income?
- Whether the expenditure is linked closely to this act?

Firstly, one needs to consider whether the purpose of the act, the rendering of services, is to produce income.

The subsidiary is incorporated for the sole purpose of managing and administering the holding company’s employee share plan. The duties and obligations of the subsidiary as set out in the service level agreement between the holding company and the subsidiary is to manage and administer the employee share plan, which includes the acquisition of holding company shares and the transferring thereof to the employees upon vesting. In return for these services being rendered the subsidiary will receive a fee together with a risk premium from the holding company as compensation for the services rendered by the subsidiary which will result in an increase in income for the subsidiary. The purpose of the expense will therefore be in the production of income.

Secondly, one needs to consider whether the expense is closely linked to the above act. Therefore, whether or not, the payment to acquire holding company shares is closely related to the subsidiary’s income producing activities, which relate to the rendering of such services as contemplated by the agreement between the two relevant parties.

As mentioned above the sole purpose of the incorporation of the subsidiary is to manage and administer the holding company's employee share plan. This includes acquiring holding company shares and transferring them to the employees upon vesting.

The payment for the purchase of the shares is therefore closely linked to the above act, as it relates to the rendering of services, and will therefore be in the production of income for the subsidiary.

The expense incurred to acquire holding company shares forms part of the subsidiary's **income producing operations (CIR v George Forest Timber Co Ltd, 1924 AD 516 (1 SATC 20))**, as the subsidiary is obliged to render such services as per the service-level agreement between the holding company and the subsidiary. The expenditure will also be on a recurring basis from time to time (when the Board meets to discuss awarding conditional shares to employees), which further supports the argument that the expense forms part of the subsidiary's income-producing operations, rather than the earning structure of the subsidiary. It can therefore be argued that it is incurred for the purpose of the subsidiary company's **trade** and would therefore **not be of a capital nature**.

### **5.3.3 Allowance of future expenditure**

The subsidiary might be entitled to an allowance of the future expenditure, to acquire the holding company shares in the open market, in terms of section 24C of the Act.

#### **5.3.3.1 Section 22 of the Act**

The effect of section 22 of the Act is:

- the value of trading stock on hand on the last day of the year of assessment, usually referred to as closing stock, is included in taxable income for that year, and
- the same amount in respect of opening stock is allowed as a deduction from taxable income in the following year.

“This means that the value of trading stock on hand on the last day of the year of assessment is in effect excluded from the cost of goods sold during that year. The effect of the trading stock provisions in section 22 is to postpone the deduction of the expense of trading stock purchased until the tax year in which that stock is disposed of. The full cost of acquiring trading stock is deductible under section 11 (a), but the effect of this deduction is matched to the years of disposal by means of the provisions governing closing stock and opening stock” (Clegg & Stretch, 2008).

### **5.3.3.2 Section 24C of the Act**

According to section 24C of the Act, “If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilized in whole or in part to finance “future expenditure” which will be incurred by the taxpayer in the performance of his obligations under such contract, there shall be deducted in the determination of the taxpayer’s taxable income for such year such allowance (not exceeding the said amount) as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion relates to the said amount. The amount of any allowance deducted in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.”

### **5.3.3.3 Analysis of Sections 22 and 24C of the Act**

One has to consider whether the holding company shares would be regarded as trading stock in the hands of the subsidiary, due to the fact that section 22 (1) of the Act would reduce the subsidiary’s income tax deduction for the acquisition price of the holding company shares by the amount of closing stock for that tax year.

This will cause significant taxable income for the subsidiary in the first tax year, during which the subsidiary acquires the holding company shares, because all shares will be included in the subsidiary’s closing stock at the end of the first year, as the shares will only vest in employees in subsequent tax years as and when the vesting conditions are complied with.

If the holding company shares are not regarded as trading stock in the hands of the subsidiary, the provisions of section 22 of the Act will not apply, thereby obviating the need for a section 24C allowance.

Based on the definition of trading stock, one has to consider the following aspects:

- If the shares were acquired by the taxpayer, namely the subsidiary, for the purpose of manufacture, sale or exchange by the subsidiary or on his behalf, or
- Whether the proceeds would form part of the subsidiary's gross income, if such shares would have been disposed of by the subsidiary.

The shares will be trading stock for income tax purposes if either one of these two aspects are applicable.

Based on the dictum from Marais J.A. in the **Richards Bay Iron and Titanium (Pty) Ltd and Another v CIR**, 1996 (1) SA 311 (A) (58 SATC 55) court case, the **purpose test** is purely a substantive test. Furthermore the point in time when this purpose must be present is also important. In **Syfrets Participation Bond Managers Ltd v C: SARS**, 2000 (SCA) (63 SATC 1) Marais J.A. stated that the purpose must be clear, at the outset, that the participations are held to be sold or exchanged.

In this case the Court held that investments in mortgage bond participations, held by a participation mortgage bond scheme manager, did not fall within the definition of the term trading stock in section 1 of the Act as the taxpayer failed to show that its participation was held for the purpose of sale or exchange by him.

It is clear from the outset, as explained in the flow of transactions in Figure 2, that the holding company shares are not acquired for the purpose of sale or exchange as:

- the shares will be acquired by the subsidiary and will subsequently be transferred to the employees of the holding company on the dates of vesting;

- no sale is contemplated upon vesting. The shares will be transferred to the relevant employees at no additional cost to the employee; and
- the subsidiary is incorporated for the sole purpose of managing and administering the employee share plan, which includes acquiring the holding company shares and the subsequent transfer thereof to the employees at the relevant time in accordance with the employee share plan.

A situation may however arise where the subsidiary may end up with a surplus amount of shares in respect of a particular share tranche after the requisite transfer to employees on vesting. This will be the case where the subsidiary bought the full amount of conditional shares earmarked for an employee, but the number of conditional shares is adjusted downwards if that employee does not meet the necessary performance criteria albeit that he/she is still in the employment of the holding company at the vesting date. Therefore such an employee will receive fewer shares on date of vesting than originally awarded to him/her on a conditional basis.

As part of the assumptions on which this study is based, one may assume that the holding company would prohibit the subsidiary to trade or deal with the holding company shares in any other manner as intended, which would be for the purposes of implementing the employee share plan. Surplus shares would be applied to subsequent share tranches and would therefore not constitute a possible change in intension of the purpose for which the shares are held, which could have led to the shares being regarded as trading stock for the subsidiary.

In addition, an objective assessment is required of whether the **proceeds** would form part of the gross income of the subsidiary, should the shares be disposed of.

Based on the ordinary meaning of “disposal”, the transfer of shares to employees upon vesting would constitute a disposal of such shares. One now needs to consider whether or not such disposal will result in an amount which will be included in the subsidiary’s gross income.



As per the trading stock definition it is clear that the amount to be included in the gross income must be the proceeds derived from the disposal of the shares and not the mere inclusion of an amount incidental to the acquisition and the subsequent disposal of the shares.

In **Syfreets Participation Bond Managers Ltd v C: SARS**, 2000 (SCA) (63 SATC 1) the Court ruled on alternative grounds that the investments in mortgage bond participations held by a taxpayer is not trading stock as defined in section 1 of the Act as the taxpayer failed to prove that there was a “disposal” and that the “proceeds” from the disposal formed part of the gross income of the taxpayer.

In this regard, a judgement was passed, stating that the taxpayer’s own involvement in the participation in the investment was temporary and incidental to its true vocation, which was to administer the investment scheme in return for an agreed commission. It was only the commission that was included in the taxpayer’s gross income.

In the subsidiary company’s instance, while the fees and the risk premium will be included in the gross income of the subsidiary, this income is included by virtue of services rendered to the holding company and does not constitute proceeds arising from the disposal or transfer of the shares to holding company employees upon vesting.

Furthermore, the transfer of the shares to the holding company employees, which constitutes the “disposal” of such shares, takes place at zero cost. Therefore the amount relating to the actual disposal of the shares equals zero.

#### **5.3.4 Conclusion for the subsidiary company**

All amounts received from the holding company, to acquire shares and to manage and administer the share plan will be included in the subsidiary’s gross income.

All the above requirements of the general deduction formula together with the limitation of section 23 (g) of the Act have been met and therefore the expense incurred to acquire holding company shares is deductible, by the subsidiary company, for South African income tax purposes.

Based on the discussion above, the shares will not constitute trading stock in the hands of the subsidiary. The subsidiary would therefore not be required to account for the closing balance of shares in its income tax calculation.

This obviates the need for a section 24C allowance, as the subsidiary should be allowed to claim the acquisition cost of the holding company shares as a deduction in terms of the general deduction formula in full in the year in which it is actually incurred.

#### **5.4 CONCLUSION**

A contextual understanding of the income tax implications of the new funding structure, where the payment to the subsidiary is structured as a fee together with a risk premium, rather than an interest-free loan, for the holding company and the wholly-owned subsidiary, have been discussed for the holding company and the wholly-owned subsidiary.

A conclusion has been reached in terms of the new funding structure, resulting in a tax benefit / deduction for the holding company and the taxability of the administration and management charge in the hands of the wholly-owned subsidiary.

Chapter 6 aims to provide a high-level comparison between the two funding possibilities, together with an overall conclusion which will address the purpose statement and research objectives of this study. Consideration will also be given to recent developments and the impact on conditional employee share schemes going forward.

## CHAPTER 6: OVERALL CONCLUSION OF THE STUDY

### 6.1 INTRODUCTION

Based on the detailed analysis performed on the tax implications of the old and new funding structures of conditional employee share plans in Chapters 4 and 5 respectively, this chapter aim to provide a high-level comparison between the two funding possibilities, together with an overall conclusion which will address the purpose statement and research objectives of this study.

Secondly, this chapter will note recent developments and their impact on conditional employee share schemes going forward.

Lastly, consideration will be given to possible future research possibilities.

### 6.2 OLD VERSUS NEW FUNDING STRUCTURES

#### 6.2.1 Overall conclusion on the tax implications of past practices

This section serves as an overall conclusion on the tax implications of past practices.

**Table 2: Overall tax position of past practices**

If we only take the transaction mentioned above into consideration to determine the impact on the holding and subsidiary company's gross income and accept all other variables, including other income and expenditure, to be zero, the overall position would be illustrated as:

	Holding company	Subsidiary company
<b>Income:</b>		
Loan amount received – subsidiary		0

Notional interest amount incurred – subsidiary		15 000
<b>Allowable deductions:</b>		
Cost of shares acquired – subsidiary		0
Loan expensed – holding company	0	
Loan expensed – subsidiary		0
<b>Gross income</b>	<b>0</b>	<b>15 000</b>

The holding company would therefore not realise any tax benefit through funding the conditional employee share plan through an interest-free loan. Furthermore, funding the scheme through an interest-free loan would result in taxable income, of R15,000 for the subsidiary.

### 6.2.2 Overall conclusion on the tax implications of the new structure

This section serves as an overall conclusion on the benefits of the new funding structure.

**Table 3: Overall tax position of the new funding structure**

If we only take this transaction into consideration to determine the impact on the holding- and subsidiary company's gross income and accept all other variables, including other income and expenditure, to be zero, the overall position would be illustrated as follows:

	Holding company	Subsidiary company
<b>Income:</b>		
Payment received from the holding company to acquire holding company shares.		100 000
Administration and management charge received from the holding company.		10 000
<b>Allowable deductions:</b>		
Payment made to the subsidiary to acquire holding company shares.	(100 000)	0
Expenses incurred by the subsidiary to acquire shares.		(100 000)
Administration and management charge paid to the subsidiary.	(10 000)	
<b>Gross income</b>	<b>(110 000)</b>	<b>10 000</b>

The new funding structure would therefore result in a total tax benefit / deduction for the holding company, amounting to R110 000. The transaction would furthermore result in taxable income for the wholly-owned subsidiary of R10 000.

### **6.2.3 High-level comparison between the two funding possibilities**

Based on the above overall conclusions reached on the two funding possibilities, the benefit to the holding company is evident. The holding company would realise an overall tax benefit through funding the conditional employee share plan through the new funding structure. Both the payments made to the subsidiary to acquire holding company shares in the open market as well as the management and administration fee, will result in a tax deduction for the holding company, compared to the interest-free loan that would not result in any tax benefit to the holding company.

The wholly-owned subsidiary will find itself in more or less the same taxable position, depending on the current market-related interest rate at which the deemed interest will be included in its taxable income and the amount of administration and management fees received from the holding company.

## **6.3 ADDRESSING THE RESEARCH OBJECTIVES**

The study aimed to achieve the following specific objectives:

- to determine if the fee and risk premium payable to the wholly-owned subsidiary would be tax deductible for the holding company in terms of section 11 (a) of the Act;
- to determine whether section 23H of the Act will be applicable to any income tax deduction claimed by the holding company, and if so, whether the deduction will effectively become available to the holding company over the vesting period or only at vesting;
- to determine whether or not the costs incurred by the subsidiary to acquire the holding company shares in the open market will be tax deductible; and

- to determine whether the future expenditure allowance in terms of section 24C of the Act will be available to the wholly-owned subsidiary.

Through the analysis of the tax implications of the new funding structure, the research objectives of the study have been met as follows:

- the fee and risk premium payable to the wholly-owned subsidiary are tax deductible for the holding company in terms of section 11 (a) of the Act;
- Section 23H of the Act will be applicable to the above income tax deductions claimed by the holding company. The payment made to the subsidiary to acquire holding company shares in the open market will be deductible, once the subsidiary applied the funds to acquire the shares. The management and administration fee paid for a specific transaction within the share plan will be pro-rated over the vesting period of such shares;
- the costs incurred by the subsidiary, are tax deductible in terms of section 11 (a) of the Act; and
- the future expenditure allowance in terms of section 24C of the Act will not be available to the wholly-owned subsidiary, due to the fact that the shares do not constitute trading stock in the hands of the subsidiary, which obviates the need for a section 24C allowance.

## **6.4 RECENT DEVELOPMENTS**

This section will discuss recent developments and the possible impact on employee incentive schemes.

### **6.4.1 Re-characterisation of domestic collective incentive schemes in securities - 1 January 2010**

An amendment to the definition of a “company” and a “person” in terms of section 1 of the Act, came into effect on 1 January 2010. For years of assessment commencing on or after 1 January 2010, domestic collective investment schemes in securities or an equity

collective investment scheme will be regarded as a “person” for income tax purposes, as opposed to a “company” in the years of assessment prior to 1 January 2010.

Furthermore, for years of assessment commencing on or after 1 January 2010, in terms of section 25BA of the Act, where amounts received by or accrued to the collective investment scheme, other than amounts of a capital nature, are not distributed to the holders of the participatory interests, within a twelve-month period, the collective investment scheme will not benefit from the exemption. Any amounts not distributed within the twelve-month period are deemed to have accrued to – and are taxable in – that portfolio.

Subsequent distribution of the above non-distributed income, will be exempt from income tax in the hands of the participatory holders, in this case the employees, as these amounts were already taxed in the hands of the collective investment scheme.

The re-characterisation of an equity collective investment scheme from a “company” to a “person”, resulted in the distribution not being subject to Secondary Tax on Companies (“STC”) or the “new” dividends tax.

#### **6.4.2 Dividends no longer exempt in certain collective incentive schemes in securities - 1 January 2011**

Companies should re-visit their employee share schemes to ensure that the scheme complies with the Act and still incentivises their employees. Employers should consider whether or not the restricted equity shares in their employee share scheme, meet the definition of an equity share.

Dividends declared to employees on restricted equity shares, after 1 January 2011, in respect of an employee share incentive scheme will no longer be exempt, unless the restricted equity shares meet the definition of equity shares or the dividend constitutes an equity instrument as per section 8C of the Act (De Koker & Williams, 2010).

An equity share is defined by National Treasury as any share or similar interest in a company, excluding shares or similar interests that do not have any right to participate beyond a specific amount in a distribution. Furthermore, the definition requires the holder thereof to participate in profits and capital distributions for the shares or similar interests to be treated as equity shares.

Therefore, ordinary shares should not be affected by the above amendments. Preference shares, which might limit the employees' right to participate in the company distributions, would result in dividends being taxable.

The change in the definition of an equity share is to align the Act with the “new Companies Act” that came into effect on 1 May 2011.

This is an important consideration for all companies with employee share incentive schemes, seeing that the above amendments have implications for both the employee as well as the employer. The employee will no longer enjoy the benefit of a tax-free dividend and the employer will have the obligation to withhold employee tax (PAYE).

#### **6.4.3 A new policy soon to be adopted by the Financial Services Board (“FSB”) regarding the registration of white label unit trust funds**



According to du Preez (2011), the FSB recently attempted to stop large collective investment schemes to register white-label portfolios on behalf of smaller unregistered managers of collective investment schemes and large independent financial advisors. Their attempt was however unsuccessful, based on the fact that the FSB's concerns were without substance, according to the FSB's Appeal Board (Du Preez, 2011).

Source: Du Preez, 2011.



The advising committee of Dube Tshidi, the registrar of collective investment schemes and the chief executive of the FSB, met to discuss possible recommendations on the registration of white-label funds at the end of March 2011. As soon as the committee finalises the recommendations, the FSB will make its policy public (Du Preez, 2011).

A draft notice has been published, by the FSB, for comment. If the notice is published finally as proposed, unit trusts will have to put their names to funds run by brokers.

According to Du Preez (2011), Bert Chanetsa, the deputy executive officer of the FSB, says, the concerning factor to the FSB, is the ability of a collective investment scheme manager to ensure that the funds registered on its licence are in compliance with collective investment scheme legislation. Another concerning factor to the board, is the fact that investors will become confused, when parties that are not registered as collective investment scheme managers are seen and branded as collective investment scheme managers. The risk attached to this practice is, in the FSB's view, untenable (Du Preez, 2011).

## **6.5 FUTURE RESEARCH**

Future research can be conducted on the impact the new developments, discussed above, would have on the future of conditional employee share plans in South Africa as well as the funding structures of these schemes, taking into consideration the “old” and “new” funding structures discussed and any possible new funding structures that will come to light to address possible limitations caused by the implementation of new legislation.

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