TAXATION CONSEQUENCES OF PROVIDING SHARES TO EMPLOYEES THROUGH A TRUST

by

CHARLÉNE FOUCHÉ
Student number 95090518

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ABSTRACT

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by

CHARLÉNE FOUCHÉ

STUDY LEADER: MR PC OPPERMAN

DEPARTMENT: TAXATION

DEGREE: MAGISTER COMMERCII

People make a company. Their expertise and talents, efficiency and job performance determine the company's profitability and growth. The long-term retention of employees is of the utmost importance, as these employees have a wealth of knowledge about the company, its industry and the products or services being sold.

Businesses have created plans to retain employees for a maximum period of time. These ideas include cash bonuses, phantom share schemes, and providing the employee with shares in the business. This study will look at such ideas in general, and specifically investigate the different ways of providing employees with shares in the business.

There are different ways of providing the employee with shares in a business. This can include loans (including interest-free loans) to the employee from the employer, loans to the employee from a financial institution, employee share ownership plans, company share option plans and providing the employee with shares in the business through an employee share trust.

Each of these methods attracts certain taxes such as income tax, capital gains tax and secondary tax on companies or dividend tax.

The aim of this study is to use a case study approach, critically analysing an anonymous company providing its employees with shares in the company through an employee share trust, and will specifically investigate the different tax consequences of each transaction taking place in the trust.

Keywords:

Company share option plans

Dividends declared to an employee share trust

Donations tax

Employee share ownership plans

Employee share scheme

Employee share trust

Employee value

Interest-free loan to a trust

Section 8 A-C

Trust

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OPSOMMING

deur

CHARLÉNE FOUCHÉ

STUDIE LEIER: MNR PC OPPERMAN

DEPARTEMENT: BELASTING

GRAAD: MAGISTER COMMERCII

Werknemers is ‘n maatskappy se belangrikste bate. ‘n Maatskappy se winsgewendheid en groei word deur sy werknemers se kennis, doeltreffendheid en werksprestasie bepaal. Dit is vir ‘n maatskappy van kritieke belang om sy werknemers vir so lank as moontlik te behou, aangesien hierdie werknemers oor kosbare kennis besit rakende die maatskappy, die bedryf waarin die maatskappy besigheid doen en die produkte of dienste wat die maatskappy bemark.

Talle maatskappy het skemas bewerkstellig om hulle werknemers vir so lank as moontlik te behou. Dit behels onder andere kontantbonusse, fiktiewe aandeleskemas en die verkryging van aandele in die maatskappy deur die werknemer. Hierdie studie ondersoek sodanige skemas in die algemeen, en fokus spesifiek op werknemers wat aandele in ‘n maatskappy bekom.

Werknemers kan aandele in die maatskappy op verskillende wyses bekom. Hierdie wyses sluit in lenings (insluitend rentevrye lenings) van die maatskappy aan die werknemer, lenings aan die werknemer van ‘n finansiële instelling, aandeleskemas, opsies om aandele in ‘n maatskappy te koop, en die verskaffing van aandele aan die werknemer deur ‘n werknemer-aandeletrust.

Elkeen van hierdie opsies het spesifieke belastinggevolge, insluitend inkomstebelasting, kapitaalwinsbelasting, en sekondêre belasting op maatskappye of dividendbelasting.

Die doel van hierdie studie is om ‘n spesifieke gevallestudie van ‘n annonieme maatskappye te ontleed, waar die maatskappy aandele aan sy werknemers deur ‘n werknemer-aandeletrust verskaf het, en sal in detail na die belastinggevolge van elke aksie in die trust te kyk.

Sleutelwoorde:

Opsieskemas vir maatskappy-aandele

Dividende verklaar aan ‘n werkemers-aandeletrust

Skenkingsbelasting

Aandele-opsies

Aandeleskema vir werknemers

Aandeletrusts vir werknemers

Waarde van werknemers

Rentevrye lening aan ‘n trust

Artikel 8A-C

Trust

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LIST OF ABBREVIATIONS

CSOPs	Company Share Option Plans
EBT	Employee benefit trust
ESOP	Employee Share Ownership Plans
SAYE	Save as you earn
SARS	South African Revenue Service
SIP	Share Incentive Plans
SIT	Share Incentive Trusts

CHAPTER 1
INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

“I’ve thought about this a lot and all that matters is money… You buy loyalty with money. This touchy-feely stuff isn’t as important as cash. That’s what drives performance” - Jeffrey Skilling, CEO of Enron (Ferguson, 2008).

People make a company. Their expertise and talents, efficiency and job performance determine the company’s profitability and growth (Boshoff & Mazibuko, 2003:31). A business should always want and need to protect its employees. The retention of skilled employees is of the utmost importance. As a result, businesses have created plans to make it attractive for employees to stay for a maximum period of time. Participative management or employee ownership is just some of the ideas to retain employees.

“In many ways employee incentive schemes are like the exercise machines advertised on television: you think you need one and rush out to buy an expensive top of the range machine, which soon ends up gathering dust in a corner” (Strauss & Haroun, 2009:8-9). Companies often introduce a scheme that is complicated, does not suit the company’s needs and is difficult and expensive to administer.

“By giving employees a stake in corporate financial transactions, their capital ownership could be paid for out of the future earnings produced by the corporation” (Katz Commission, 1997).

According to Boshoff and Mazibuko (2003:31) there is often a wide gap between management objectives and employee expectations. Management usually wants to increase the company’s profitability, whilst employees are generally more concerned with their own pocket and as a result their own profitability. It is imperative that this gap is closed for the future benefit of both parties. Over the years, efforts have been made to close the gap between management objectives and employee expectations. One of these solutions was to provide employees with shares in the company that they are working for. This is seen as a reward for contributing to the company's profitability. Some researchers have speculated that making an employee a shareholder in the business will increase his/her passion for the business. As stated by Pierce and Furo (in Strauss, 2010:10), "Employee ownership can have a positive effect on a workgroup's norms, cohesiveness, and cooperative behaviour; on an employee's work-related attitudes, motivation, and behaviour; and on an organisation's performance and profitability". By making an employee a shareholder in the business he/she will be working for him-/herself and as a result will be motivated to work harder.

When a business decides to reward its employees, regardless of whether it is with money, assets or shares, it will always attract tax. The taxable amount will be calculated by deducting the consideration paid for the reward.

In the law of trusts, one often finds a discrepancy between the intention of the trust and the practical implementation thereof. A trust's inherent flexibility and ease of use often leads to inappropriate solutions to try and avoid paying tax. The avoidance of tax must not be confused with the evasion of tax. Tax avoidance is legal whilst tax evasion is illegal.

Trusts were not created for beneficiaries and trustees to avoid tax, but to protect the assets of the beneficiaries, and minors who may be incapable of managing the assets themselves. Through the years trusts known for their extreme adaptability, have evolved to be tax saving entities in certain instances.

According to Strauss (2010:10), employee ownership plans are not necessarily effective. "Since the introduction of Section 8C of the Income Tax Act, employers and employees must accept that, if an employee gets a share by virtue of his employment, the employee will suffer income tax (as opposed to capital gains tax) on any profit he or she makes on the disposal of the share. No doubt attorneys and accountants will think of ways to avoid that provision; but SARS will continue to close loopholes".

1.2 PURPOSE STATEMENT

Whenever a company provides its employees with benefits for no consideration, tax consequences will arise. Companies all over the world have tried ways to reward their employees' tax free. This study will use a case study approach to investigate if the company in question succeeded in providing its employees with shares tax and cost free.

1.3 RESEARCH OBJECTIVES

The study will be guided by the following research objectives:

- to critically investigate different methods of retaining and rewarding employees;
- to analyse if the AE Trust (an anonymous trust) meets all the requirements to be a trust and to critically evaluate whether the purpose of the AE Trust (to provide employees with shares tax free) is achieved through the trust deed;
- to compare the essence of the AE Trust with a Broad-Based Employee Share Plan;
- to investigate the tax consequences of providing shares through the AE Trust deed;
- to investigate Section 8 of the Income Tax Act 58 of 1962;
- to investigate new legislation's effect on employee share trusts; and
- to establish whether there are better ways to structure the transaction to optimally benefit all parties involved.

1.4 IMPORTANCE AND BENEFITS OF THE STUDY

This study will provide answers on whether the AE Trust fulfils its objective of providing XYZ (an anonymous company) employees with shares in XYZ, and whether this is the most effective way of doing so.

1.5 DEFINITION OF KEY TERMS

This study involves a number of key concepts, which are defined below.

XYZ: In the case study XYZ is a fictitious, privately owned company in South Africa with fifty employees.

AE Trust: In the case study the AE Trust is a fictitious trust created by XYZ to provide XYZ employees with shares in XYZ.

Beneficiary: A natural person that receives money or other benefits from a trust, either now or at a date in the future.

Broad-Based Employee Share Plan: A plan by a company in which employees receive equity shares in that company for consideration which does not exceed the minimum consideration required by the Companies Act, 1973 (SAICA, 2010b:43). Van Schalkwyk (2008a: 314) stipulates that the following criteria should be satisfied for a scheme to qualify as a broad-based employee share plan:

- equity shares in that employer that are obtained by the employee for no or minimal consideration;
- at least eighty per cent of permanently employed employees are allowed to participate;
- the employees who acquired the equity shares are allowed full voting rights and are entitled to all dividends in relation to the shares; and
- no restrictions have been imposed on the equity shares, aside of restrictions imposed by current legislation; a right retained by a person other than the employee to acquire the shares from the employee on the date of acquisition, at market value; a right of the employer to acquire the equity shares from the employee at market value on date of grant due to the misconduct or poor performance of that employee; and a restriction that the employee may not dispose of the share for a maximum period of five years.

Company share option plans (CSOPs): A company can award employees with options to purchase shares in the company at a future date

Conduit for passing income: Mechanism to channel income to beneficiaries in a trust.

Connected person in relation to a shareholder: Any relative of that shareholder or any trust in which that shareholder or a relative of the shareholder is a beneficiary (SAICA, 2010:9)

Consideration: Something of value given by both parties. Also known as compensation.

Dividend: Any amount distributed by a company to its shareholders (SAICA, 2010b:11)

Dividend withholding tax: A company paying a dividend to a shareholder is legally obliged to withhold the tax on the dividend from the amount paid to the shareholder, and pay the tax over to SARS (De Swardt, 2008:498).

Donation: Presenting something as a gift or contribution, including any relinquishment of right to an asset at no charge.

Donations Tax: Donations tax is payable on the transfer of assets from one entity to another. It is the value of any property disposed of by a South African resident through a donation, including property donated to a trust. (Oosthuizen, 2008:669)

Employee ownership: Providing the employees of a business the opportunity to become shareholders in the business, through the purchasing of shares directly in the company or by being given an option to buy shares in the business, through worker cooperatives or by the ownership of shares through some kind of employment trust.

Employee share ownership trust: Trust accounts through which employers can sell shares to their employees.

Equity Instrument: A share, members interest in a company, share option, financial instruments that are convertible to shares or members' interest and any right with reference to shares or members' interest (Arendse, 2007:15-16). The share or right must have been obtained by a person's service as a director, an employee's agreement with his/her employer, or by virtue of the fact that the employee held other restricted qualifying equity instruments (Van Schalkwyk, 2008a:315-316).

Equity share: A share that excludes shares that have no participation rights beyond a certain amount distributed. It includes preference shares or shares that do not allow one to participate beyond a certain amount (Brincker, 2011:2).

Extraordinary dividends: Any dividend received within a period of 18 months before the disposal of the shares, which exceeds 15 per cent of the yield of the disposal or part disposal (Koekemoer, 2010:924).

Fiduciary duty: A legal or ethical affiliation of confidence or faith regarding the management and care of assets between two parties (Wikipedia, Not dated).

Founder of a trust: The creator of the trust, also known as the donor.

Identity of trust income: The income of a trust retains its identity until it reaches the parties in whose hands it is taxable, such as the beneficiaries. (*Armstrong v CIR, 1938 AD 343, 10 SATC 1*). If a trust receives dividend income and pass it on to its beneficiaries in the same year, it will be treated as dividend income in the hands of the beneficiary.

Mr X: The founder of the AE Trust and a majority shareholder in XYZ.

Participative Management: Participative Management (otherwise known as employee involvement or participative decision-making) promotes the contribution of all stakeholders at all levels of the business, including the scrutiny of complications, improvement of strategies and execution of solutions (McMillan: 2006). Employees are invited to participate in activities such as setting objectives, defining work programs and making recommendations. Participative Management involves more than agreeing to let employees participate in making decisions. It also involves management treating suggestions with consideration and respect. Four processes are involved in participative management – information sharing, training, employee decision-making and rewards that are tied to suggestions and ideas as well as performance.

Qualifying equity share: Share(s) that an employee acquires in terms of a broad-based employee share plan of which the value may not exceed fifty thousand rand in market value for five consecutive years (Van Schalkwyk, 2008a:313-314).

Restricted equity instrument: Include a contractual commitment or right. The value thereof is determined by the related share (Brincker, 2011:1).

Save as you earn, share save, or savings-related option schemes (SAYE): The employee uses the earnings of a savings arrangement to fund the purchase of the shares provided by a share option.

Secret profits: A profit made by an employee making unauthorised use of employer's assets for his/her own benefit or a trustee using trust assets for his/her own benefit.

Share incentive plans (SIP): Share incentive plans give employees the opportunity to receive shares in their employer. Shares can consist of free shares, partnership shares, matching shares and dividend shares (Anon, Practical Law, 2011).

Share incentive trusts (SIT): Share incentive trusts hold shares on behalf of employees in their employer (Spamer, 2008).

Shareholder: An individual, group or organisation that owns one or more shares in a company.

Tax Avoidance: Legal activities embarked on by a taxpayer to reduce his/her taxable income with the result that no or little tax is payable (Van Schalkwyk, 2008b:657).

Tax Evasion: Illegal activities embarked on by a taxpayer to free him-/herself from a tax burden **(**Van Schalkwyk, 2008b:657).

Tax Liability: The total amount of tax that an individual, business or trust is obligated to pay to the South African Revenue Service.

Third party backed shares: Shares obtained where the holder of the shares had the right to appoint another party other than the company issuing the shares, to acquire the shares from the holder.

Trust: A lawful association consisting of cash or other assets, which are administered and controlled by a person with the legal authority to do so, on behalf of someone else.

Trustee: An individual appointed through a will or by a court order that is in control of any asset or property belonging to a trust, manages the assets for the benefit of someone else, or acting in a fiduciary capacity with regard to property belonging to a trust (SAICA, 2010:28).

Trust deed: A legal document that outlines the trust agreement.

Vested interest: An entitlement to assets in a trust.

1.6 RESEARCH DESIGN AND METHODS

A case study is a thorough investigation of a specific individual or occurrence for a set period of time (Leedy & Ormrod, 2010:137-138). As this research proposal’s focus is specifically toward the anonymous employee share trust (AE Trust) of an anonymous company (XYZ), the research done will be classified as a case study. Information regarding the employee share trust transactions will be collected and analysed. Conclusions will be drawn about the share scheme and its findings might be of benefit to other companies in a similar position.

Leedy and Ormrod (2010:138) specify the following steps involved in a case study analysis:

- compiling and organising of details about the case;
- labelling and cataloguing of data;
- analysis and explanation of certain events;
- detecting patterns; and
- composing an overall depiction of the case study in question, and reaching conclusions.

Since employee share schemes are becoming more common in South Africa, it is important to look at the various ways of structuring such a scheme. To provide the shares to employees in an employee trust is just one of the ways of doing so. It is therefore important to investigate all the legal and tax consequences of such a trust. In this particular case study the AE trust deed was examined.

1.7 DELIMITATIONS

This study specifically focuses on the XYZ case study and only the facts of this case study will be discussed. Whilst certain elements of this study might pertain to other companies and their share trusts, this study will specifically look at the tax consequences and limitations of the AE Trust.

1.8 ASSUMPTIONS

This study makes certain assumptions about the XYZ case study. It is assumed that XYZ has provided all information pertaining to the AE Trust, the AE Trust Deed and XYZ's intentions regarding the employee share scheme.

1.9 OVERVIEW OF THE CHAPTERS

This chapter provide the background information and purpose for the study. The research objectives are discussed, together with the benefits of the study, as well as certain delimitations and assumptions.

Chapter two investigate the reasons why employees should be retained and methods of providing employees with ownership in a business.

Chapter three investigates the requirements of a trust and critically evaluate if the AE Trust can be classified as a valid trust.

Chapter four provides information on the tax implications for both the individual and the trust.

Chapter five concludes the study with and provide alternative methods of rewarding employees.

CHAPTER 2

REASONS FOR AND METHODS OF PROVIDING OWNERSHIP TO EMPLOYEES

2.1 INTRODUCTION

South Africa is known for its infamously low productivity in certain areas, and this has dire consequences on the South African economy. Low labour productivity tends to increase export prices and makes the local market more vulnerable to overseas competitors (Boshoff & Mazibuko, 2003:31). Employee share ownership plans were first introduced to South Africa in 1987, following the investment removal from international companies in the South African market. According to Leoka (1990) in Boshoff and Mazibuko (2003:31) at the time, some unions rejected the idea, whilst the majority saw the benefit of having an employee share ownership plan for their union members, on the condition that certain criteria were met. According to Maller (1987) in Boshoff and Mazibuko (2003:31), these conditions included:

- wage levels had to be upheld;
- conditions of employment are independent of share ownership;
- all employees are entitled to shares;
- shares must be self-financed;
- the trusts must be democratically controlled;
- the employee ownership plan must be open to consultation;
- the trade union must be involved from the start in the employee share ownership plan; and
- there must be full disclosure of information concerning the employee share ownership plan and the company in which the shares will be obtained.

There often is a gap between management objectives and employee expectations. It is in the interest of both parties to close this gap, and mutual effort is required to do so. By closing the gap, a change is required in the attitudes of both employees and management. Employees are mostly concerned with their own survival. Due to a lack of communication from management, employees can very easily feel demotivated. An attitude that the employees do not share in the rewards of their efforts, and that their opinions are not really considered are common amongst many employees (Boshoff & Mazibuko, 2003:31).

"As far as the company is concerned, institutional shareholders come and go. An employee shareholder trust would be there for the long haul." (Michie & Oughton, 2001:4).

"Empowerment is the sharing of information with employees about the organisation's performance, rewards based on the company's performance, knowledge that enables the employees to understand and contribute to the company's performance, and power to make decisions that influence the organisational direction and performance." (Boshoff & Mazibuko, 2003:32-33).

2.2 ADVANTAGES OF MAKING EMPLOYEES OWNERS IN THE BUSINESS

Making employees owners in the business can have numerous advantages.

- By making an employee a shareholder in the business, his/her enthusiasm for the job is stimulated. Enthusiastic employees will:
  - work harder;
  - complain less;
  - have lower absenteeism from work;
  - lower staff turnover (Mazibuko & Boshoff, 2003:31) and
  - improve the company culture (Senate Economics References Committee, 2009:8).
- Non-quantifiable advantages such as prestige and the status of owning shares (Weifeng, Zhaoguo & Shasha, 2007:286).
- Help to align the interests of both employees and shareholders to encourage senior executives to consider the best interests of shareholders in their management of the business (Anon, Practical Law Company, 2011).
- Reduced employment costs. Equity incentives can improve the general economy and tax legislation has therefore been used to provide tax reliefs in particular employee share scheme structures (Anon, Practical Law Company, 2011).

- Employees with shares in a company have an interest in the financial outcomes of the said company and as a result are motivated to a higher level of performance and productivity (Arendse, 2007:15-16).
- Since employee share schemes promote employee retention, companies can afford to invest money on employee education. Better educated employees lead to a more dynamic and lucrative company (Senate Economics References Committee, 2009:8).
- Provide reward or advantage to employees with outstanding performance (Buck, 2008:1-2).
- Provide a succession plan for the current shareholders of the company (Buck, 2008:1-2).
- The trust can act as a communication tool between the company and the employees regarding the shares and can fruitfully be used to capture value for the employees that are beneficiaries in the trust (Hamilton & Nuttall, 2005:2-4).
- The existing company capital can be increased (Senate Economics References Committee, 2009:8).

2.3 DRAWBACKS OF MAKING EMPLOYEES OWNERS IN THE BUSINESS

Making employees owners in a business can also have numerous drawbacks.

- For existing shareholders:
  - lose control of the business; and
  - when additional shares are issued to the share scheme, existing shareholders' shareholding is diluted (Boshoff and Mazibuko, 2003:31).
- For employees:
  - as a financial investment, it makes more sense to hold shares in another company than the one for which the employee works – should that company be insolvent, the employee risks losing their savings as well as their monthly earnings (Michie & Oughton, 2001:4-8);
  - if an employee receives shares by virtue of his/her employment, the employee will suffer income tax on any profit he/she makes on the disposal of the share;

    - employees may feel that more work is expected from employees who have shares in the business (Boshoff & Mazibuko, 2003:32);
    - employees may feel that they can not participate in strikes if they have shares in the business (Boshoff & Mazibuko, 2003:32); and
    - employees may choose to be lazy and benefit from other employee shareholders' hard work (Senate Economics References Committee, 2009:8).
- For managers:
    - employees may overrate their importance because they are shareholders in the business (Boshoff and Mazibuko, 2003:32);
    - managers must be prepared to surrender some control to their workers (McMillan, 2006); and
    - employee share ownership may encourage too much participation by employees in decision-making resulting in the undermining of management authority (Boshoff and Mazibuko, 2003:32).
- For the company:
    - the employer is responsible for withholding employees tax (PAYE) on benefits employees receive through share incentive schemes;
    - the company may not necessarily get a deduction of all the costs in respect of the share incentive scheme;
    - financial information pertaining to the company must be shared with the employees;
    - share incentive schemes necessitate significant administration (Strauss, 2010:4-6);
    - according to section 144A of the Companies Act of 1973, the company must employ a compliance officer to administer the share incentive scheme;
    - short-term interests of shareholders may favour dividend pay-outs as opposed to spending money on research and development and other investments (Michie & Oughton, 2001:4-8);
    - employee owned companies tend to grow slowly and take fewer risks (Senate Economics References Committee: Australia, 2009:13); and
    - often the responsibility of the supervision of the scheme becomes the responsibility of the financial director of the company. Since the one of the

primary responsibilities of the financial director is the sound financial management of the company, the share scheme and its management are often neglected (Strauss & Haroun, 2009:8-9).

- Time aspect of the reward – some time might pass before the employee is rewarded with dividends. In some instances, it may be better to reward the employee with cash bonuses instead.

2.4 METHODS OF PROVIDING OWNERSHIP TO EMPLOYEES

There are different ways of providing ownership to employees, with and without tax consequences.

2.4.1 Employee share purchase assisted through a bank loan

The employee can obtain a loan from a commercial bank and purchase shares from one of the shareholders. However, it may be difficult for the employee to obtain a loan, depending on the loan amount needed and the solvency of the employee. There also has to be a shareholder willing to part with some or all of his/her shares.

2.4.2 Employee share purchase assisted through a loan from the company

According to section 44 of the Companies Act no 71 of 2008 (SAICA, 2010:204), a company is allowed to assist an employee (by providing financial assistance by way of a loan) to purchase shares in the company. This must be authorised by the company's Memorandum of Incorporation. The board of directors may only authorise financial assistance if the assistance is related to an employee share scheme that satisfies certain requirements. The board must be satisfied that the company will comply with the solvency and liquidity tests immediately after providing the financial assistance to the employee, and the terms under which the financial assistance is provided to the employee must be fair and reasonable to the company. According to section 97 of the Company's Act no 71 of 2008 (SAICA, 2010:226), the requirements for having an employee share scheme include the following:

- the company must appoint a compliance officer for the scheme to be answerable to the board of directors of the company in which the shares are held;
- the company must state in its financial statements how many shares were allotted during that specific financial year to the employee share scheme; and
- the compliance officer must comply with the following requirements:
  - the compliance officer must administer the scheme;
  - the compliance officer must provide each employee that receives an offer of shares with a written statement, clarifying the following:
    - comprehensive details of the nature of the transaction, including any risks associated with the transaction;
    - certain information concerning the company, including financial statements and three year's profit history and
    - full details of any substantial changes that occurred during the financial year in question
  - the compliance officer must file copies of the written statement as mentioned above within twenty days after the formation of the employee share scheme; and
  - the compliance officer must file a certificate, stating that the compliance officer has complied with the obligations as mentioned above, within sixty business days after the company's financial year-end.

Loans to employees generally have tax consequences associated with the loan transaction. The Seventh Schedule of the Income Tax Act no 58 of 1962, paragraph 2(f) (SAICA, 2010:283) states that any loans from a company to an employee with little or no interest payable by the employee to the company is classified as a fringe benefit to the employee. The employee will be taxed on the value of this fringe benefit. The value is calculated as the difference between the interest paid by the employee and the official interest rate as specified by the South African Reserve Bank. Should the loan to the employee be to facilitate the purchase of shares as set out in Section 8B of the Income Tax Act No 58 of 1962, no taxable benefit will arise. The requirements of Section 8B will be discussed in chapter four.

2.4.3 Employee share purchase repaid by the employee

Shares can be financed through contributions from salaries, salary sacrifice agreements, performance bonuses or through profit sharing (Senate Economics References Committee, 2009:6).

2.4.4 Employee share ownership plans (ESOPs)

Companies in which employees own shares have a competitive advantage with regard to productivity when compared to traditionally owned companies (Buck, 2008:1-2). An employee share ownership plan can also be known as an employee share trust or an employee benefit trust (EBT) (Hamilton & Nuttall, 2005:2-4). According to Hamilton and Nuttall (2005:2-4) a basic employee share ownership plan has trustees (usually a professional trustee company or directors of the company) and beneficiaries (the employees participating in the scheme). The company usually appoints the trustees, but the employees may also have a say in the selection. The trustees will decide who receive cash or shares, the amount thereof and the date of the transaction. The trustees may also decide to hold the shares in a trust and not distribute it to the beneficiaries. The shares may also be held in trust for a short period of time before it is distributed to some or all beneficiaries of the trust. The trust will avoid numerous different employees holding shares and combine it to one shareholder.

An ESOP may also be used as an exit tool for founder or family shareholders, particularly where the company wants to retain its independence. (Hamilton & Nuttall, 2005:2-4). Through an ESOP the employees may be provided with a long-term savings plan (Equiom, n.d.:1).

Most ESOP's have the following or similar features:

- the employees obtain the shares at a discounted value;
- disposal of shares are only allowed after a suitable period of employment or after certain criteria have been met;
- the employee has to give up the shares upon resignation or employment termination; and

- there usually is a period between the award of the shares and the time at which the employee becomes entitled to those shares (Senate Economics References Committee: Australia, 2009:13).

2.4.5 Company Share Option Plans (CSOPs) or Employee stock option schemes

Company share option plans enable companies to grant options to their employees to purchase shares in the company at a future date at a set price. O'Donnel, Tracey, Bontis and Cleary (2005:3) argue that stock options are agreements that provide the employee with the opportunity to buy a share at a specific price, also known as the exercise price. Often the exercise price is equal to or greater than the market value of the share on the date of the grant of the option, with the anticipation that a profit will be made when the option is implemented at a future date. Employee stock options are usually non-tradable and the employee will lose his/her option to purchase shares at a future date when he/she leaves the employment of the company.

A CSOP is risk free for the employee as there is no financial commitment or obligation to implement the option. The price of the option may not be less than the market value of the share at the time of the grant (Anon, Practical Law Company, 2011).

CSOP's are usually developed to increase employee affection to the company instead of providing monetary rewards (Senate Economics References Committee, 2009:4).

CSOP's can be divided between broad-based schemes offered to general employees and executive schemes offered to directors and key executives. Executive schemes link company performance to rewards paid and encourages the long-term employment of key executives. Executive schemes usually reduce the risk of makeshift solutions and the expense of the company in the long run (Senate Economics References Committee, 2009:4).

2.4.6 History of employee share ownership plans

The concept of employee share ownership plans was mainly developed by Dr Louis O. Kelso in the United States of America, who argued that the equal sharing of wealth could only be obtained through extensive capital ownership. According to Dr Kelso, the majority of capital-producing assets i.e. shares are owned by a small group of people. The majority of people did not have the necessary funds to buy into the capital-producing assets. Only by sharing in the ownership of these capital-producing assets would the majority of people be able to enhance their current income (Katz Commission 1997).

Since the typical employee did not have access to the necessary funds to buy into these capital-producing assets, share employee ownership plans were devised by Dr Kelso as a means to assist the typical employee to purchase shares in a corporation.

From 1969 to 1974, the norm in South Africa was to provide shares to employees on a partly paid, interest-free basis. This was declared unlawful in 1974 when the Companies Act No 61 of 1973 came into operation through the provisions of section 92. This law required that no shares will be issued by a company unless the full payment for such shares has been received by the company (SAICA,2010b:29). From 1974 onwards the norm was to issue shares to a trust and the company would then loan money to the trust interest-free to pay for the shares. The trustees would then sell these shares to the employees of the company. As a result the employee enjoyed long-term interest-free credit to pay for the shares. This all changed in 1984 when the Seventh Schedule of the Income Tax Act of came into effect. As a result any interest-free loans were taxed as a fringe benefit (Katz Commission: 1997).

2.5 CONCLUSION

There are both advantages and disadvantages of having employees as shareholders in a business. The advantages outweigh the disadvantages by far. The most important advantage is that employees will be retained within a company for longer periods and the workforce will be sustained. Employees will also be motivated, more productive and will have a more positive attitude. There are various methods available to assist employees in obtaining shares in a business, some more favourable than others. Chapter 3 will investigate employee shares trusts further and critically analyse the AE Trust deed.

CHAPTER 3
EMPLOYEE SHARE TRUSTS

3.1 INTRODUCTION

According to Stark (2010:800), the Hague Convention defined a trust in 1986 as the legal relationship created a) during the lifetime of the creator or b) upon the death of the creator, who places effects under the control of someone else to the advantage of a recipient or for a specific purpose. The creator of the trust appoints trustees who act in a fiduciary capacity. The main objective of an employee share trust is to avoid employees trading with shares, whilst at the same time still enjoy the advantages of such shares through the employees' vested rights to the shares (Spamer, 2011:2).

Trusts can be categorised between

i) Mortis causa trust (a trust created upon the death of the creator)
ii) Inter vivos trust (a trust created during the lifetime of the creator)

An inter vivos trust can be classified as a vested trust or a discretionary trust.

- Discretionary trust: The trustees have full power to decide if and when the beneficiaries will benefit and unallocated trust income is taxed in the trust.
- Vested trust: The benefits of the beneficiaries are determined by the trust deed and trust income is taxed in the hands of the beneficiary.

Three parties are involved in an inter vivos trust:

i) the creator or founder of the trust;
ii) the trustees of the trust; and
iii) the beneficiaries (can include other trusts, companies or human beings) of the trust.

A lawyer has to draw up the trust deed and the trust has to be registered at the High Court (eTrust, 2009)

In the past there were certain tax benefits to have assets in a trust, but current legislation has put an end to it. These days trusts are most often used to protect assets from creditors. The term asset protection is frequently misinterpreted. The purpose of asset protection is not to hide assets, as a person would still have to declare all assets if needed. Asset protection involves removing the legal title of the asset from the person, whilst the person still retain the control and benefits of the thereof.

3.2 Advantages and disadvantages of a trust

There are numerous benefits and drawbacks of a trust, which will now be investigated.

3.2.1 Advantages of a trust

A trust can have the following advantages:

- a trust does not die and can continue to exist for more than one generation. A trust survives the individual, and can only come to an end upon mutual agreement, or the happening of a certain event or date as specified in the trust deed;
- a trust can hold assets to the benefit of minor children of mentally disabled individuals;
- a trust can protect an individual's assets from creditors; and
- a trust can be a mechanism to save tax as income and capital gains can be distributed to beneficiaries (Cliffe Dekker Hofmeyr, 2011).

3.2.2 Disadvantages of a trust

A trust can have the following disadvantages:

- the donor of the asset looses control of the asset that is transferred to the trust;
- administration responsibility is required to operate the trust;
- costs may be incurred for professional services i.e. legal or accounting fees;
- certain income tax disadvantages may exist, such as higher transfer duty when purchasing property, a high income tax rate of forty per cent, no qualification for rebates or exemptions and

- the trust may not be used as an alter-ego for the donor (Cliffe Dekker Hofmeyr, 2011).

3.3 Requirements of a valid trust

iProtect (2009) argues that the following are necessary requirements to form a lawful trust:

- the creator's resolve must be to create a trust;
- the trust deed must create a binding commitment;
- the trust assets must be easy recognisable;
- the trust's purpose must be unmistakeably clarified;
- the trust's purpose must be legitimate; and
- the beneficiaries must be selected. If a trust does not have beneficiaries the trust will cease to exist and the trust assets will be transferred back to the donor thereof.

3.4 Duties of the trustees

According to Sebenza Business Solutions (not dated) the trustees have the following vital duties:

- to keep accurate records of the trust's finances;
- to have regular trust meetings;
- to keep minutes of all trust meetings and decisions;
- to submit the trust's income tax returns to SARS;
- to act in good faith with regards to the trust assets;
- to act in compliance with the trust deed;
- trustees are not allowed to speculate with the trust's assets; and
- trustees are not allowed to make secret profits

Diniz (2011) add the following duties:

- a trustee must lodge the trust deed with the master of the high court;
- a trustee must obtain authority from the high court to act as a trustee;
- a trustee must open a bank account in the name of the trust;
- a trustee must clearly classify and outline trust property;

- trust property must never form part of the estate of the trustee; and
- a trustee must certify that trust property generate reasonable proceeds where possible.

3.5 Rights of the beneficiaries:

Cliffe Dekker Hofmeyr (2011) argues that beneficiaries have two types of rights:

- Vested right: The beneficiary is entitled to something (either assets or income in the trust)
- Discretionary right: The beneficiary might potentially benefit from the trust but only as and when the trustees see fit.

3.6 Share incentive trusts

Share incentive trusts have been used for relatively long periods as structures to implement employee share incentive schemes. Unfortunately, Section 8C of the Income Tax Act No 58 of 1962 has led to the increasing unpopularity of share incentive trusts.

A share incentive trust would be useful when an employer would like to issue some of its shares for specific current and future employees. The advantage is that these employees are allowed to share in the company's profits, but are not part of the decision-making processes of the company, and restrictions are placed on trading with the shares.

As employees generally do not have sufficient means available to purchase shares, the share incentive trust may require third party funding for the purchase through either a loan at a bank or a loan from the employer.

Once the shares have been purchased, the employees receive a vested right in the income and gains of the share incentive trust as opposed to rights to the shares. The employees are not allowed to sell, dispose of or cede their rights to the income and gains of the trust before the shares are not disposed of by the share incentive scheme. As the employees do not have rights in the shares itself, the trustees of the share incentive scheme are sanctioned to dispose of the shares at their sole discretion. The trustees retain the voting rights attached to the shares for the benefit of the employees until the shares have been disposed of.

3.7 Discussion of the AE Trust and the AE Trust deed

The anonymous AE Trust and the intention of the trust will now be discussed in more detail.

3.7.1 Background and intention of the AE Trust

During an interview conducted with Mr X, Chairman of XYZ (a private company registered in South Africa with fifty employees that will be treated anonymously in this study), on 23 March 2011, he stated that the purpose of the AE Trust was to assist XYZ in retaining staff. XYZ is situated in an industry where exceptionally skilled individuals that are specialists in their field are employed. As a result it is imperative for XYZ to retain its staff on a long-term basis – when qualified, competent employees leave the company's employment they take with them exceptional skills and a wealth of knowledge of XYZ's products and pricing structure.

In order to retain its highly skilled employees, XYZ has decided to incentivise the executive territory and marketing managers by providing them with twelve per cent shares in XYZ in such a way that they receive the shares tax free. The main shareholder of XYZ would sell twelve per cent shares to the AE trust (an inter vivos trust) at a market related value. XYZ would then lend funds interest-free to the AE Trust in order to purchase the shares in XYZ from Mr X. The loan would be repaid by the annual dividends that are declared by XYZ. Once the loan is repaid, the remaining dividends would be deposited into the AE Trust bank account, to be distributed at a later date.

The beneficiaries of the AE Trust will be the executive territory managers and executive marketing managers employed by XYZ. When the AE Trust was created there were twelve territory and marketing managers (known as the original twelve). As the AE Trust obtained twelve per cent shareholding in XYZ, it was commonly understood that each one of the original twelve would receive one per cent in XYZ.

In order to qualify as a beneficiary of the AE Trust, a territory or marketing manager would have to be permanently employed by XYZ for a period of at least two years. Once a new territory or marketing manager is eligible to become part of the AE Trust the beneficiaries will decide in conjunction with the chairman from XYZ if the individual would qualify. This would be done by a majority decision. This is in an attempt to motivate new managers to work productively and create revenue for XYZ, and retain employees.

The original twelve also had the option to decide how much shareholding they are willing to part with when new beneficiaries were added to the trust. Any new beneficiaries might not necessarily receive the same number of shares as the original twelve, or as any other beneficiary of the trust.

A beneficiary would have to be part of the trust for a minimum of five years before they become eligible to receive dividends from the trust. Any dividend payments made within the first five years would be allocated against the repayment of the loan. Any dividend payments paid out over and above the loan amount would be deposited into the AE Trust bank account, and would only be paid out after the five year period has expired. Should a person leave the employment of XYZ before the five year period is over, the person would automatically lose any claim that he/she had at the shares. This is regardless if a person resigns or is dismissed. Once the five year period has come to an end for a beneficiary, he/she would receive his/her shares in XYZ and they would have the option to keep their shares in the AE Trust or sell their shares. Each individual would be able to make his/her own decision.

If a beneficiary decided to sell his/her shares, they would have the option of either selling it back to the trust, or to sell it to an existing XYZ shareholder.

Should a beneficiary become insolvent, it would be deemed that he/she has died. Should a beneficiary pass away before the shares have vested in him/her (i.e. before the five year period has expired) he/she would lose all claim to the shares in XYZ.

The AE Trust would have three trustees at all times. Two of the trustees will be chosen from the original twelve territory- and marketing managers and the third trustee would be an independent trustee.

3.7.2 Does the AE trust deed comply with the requirements to be a valid trust?

The first step is to critically analyse the AE Trust deed, to see if it comply with the minimum requirements to qualify as a valid trust in South Africa.

In order to qualify as a valid trust, the following criteria have to be met:

- the creator's resolve must be to create a trust – XYZ's intention was to create a trust as a vehicle for selling shares to their executive territory and marketing managers;
- the trust deed must be a binding commitment – The AE Trust's deed is a binding contract;
- the trust assets must be easy recognisable – The AE Trust's assets are the shares in XYZ;
- the trust's purpose must be unmistakeably clarified – The purpose of the AE Trust is to obtain assets on behalf of the beneficiaries (the executive territory and marketing managers of XYZ) and administer and dispose of these assets for the benefit of the beneficiaries. Section 3 of the AE Trust deed (2010:3) stated: *"All property acquired by the trustees in their capacity as such shall vest in the trustees to be administered and disposed of according to the provisions of the trust deed for the benefit of the beneficiaries.";*
- the trust's purpose must be legitimate – it is appropriate and valid to sell shares to employees, using a trust as the vehicle; and
- there must be beneficiaries selected – Section 4 of the AE Trust (2010:3) defines the beneficiaries as "4.1 For purposes of the trust the class of beneficiaries mentioned in clause 4.1.1 will be income beneficiaries as well as capital beneficiaries and shall be: 4.1.1 The beneficiaries will be the 'Executive Territory Manager(s)' and the 'Executive Marketing Managers(s)' of XYZ that are described as such in terms of their individual employment contracts with XYZ. 4.1.2 If a person described in clause 4.1.1 should, for whatever reason loose his/her title of

‘Executive Territory Manager’ or ‘Executive Marketing Manager’ with XYZ he/she will no longer form part of the class of beneficiaries mentioned in clause 4.1.1 *supra* and will immediately loose any and all rights that he or she might have had as a beneficiary of the trust.”

From the above requirements it is clear that the AE Trust Deed complies with the minimum requirements to be recognised as a valid trust in South Africa.

3.7.3 <u>Potential problems with the practical execution of the AE Trust deed</u>

According to Mr X, the original twelve had the option to decide if they wanted to add new executive marketing and territory managers to the trust as fellow beneficiaries. The moral dilemma that the original twelve faced was two fold. One – if they added another beneficiary to the trust, their shares would be diluted (they would not each own one per cent in XYZ anymore) and their share of dividends would have to be divided over more beneficiaries and as a result their net payment would be reduced. The second dilemma was that if they did not add the executive territory or marketing manager as a beneficiary of the trust, the person would become demotivated and leave the employment of XYZ, taking with them a wealth of knowledge and skills.

It was also explained to the original twelve they had the option to decide how much shareholding they are willing to part with, using a majority decision, and that new beneficiaries did not necessarily have to receive the same percentage of shares as what they had. Again there were problems with this – if the original twelve did not unanimously decide to add an individual as a beneficiary, the beneficiaries that were opposed to the idea’s shares would still be diluted in the process even if they did not agree to it. This had the potential to cause a lot of conflict between the beneficiaries. Also, if some beneficiaries only had a few shares, they might end up with basically no shares at all if new beneficiaries were added to the trust.

Once a beneficiary has become entitled to his/her shares, he/she had the option to sell it. Two problems can potentially arise. Firstly, it might be difficult to find an interested buyer to purchase the shares. Secondly, the beneficiary might be forced to sell his/her shares at a value below market value due to a lack of sufficient funds from interested buyers.

The last issue is that the trust might run out of shares to distribute to beneficiaries if all beneficiaries sell their shares to existing shareholders outside the trust. The trust would therefore have to be in a financial stable situation with funds available to purchase shares from beneficiaries when they want to sell it to prevent the trust from running out of shares.

3.8 Conclusion

From the discussion above, it is clear that a trust has certain requirements that must be fulfilled in order for it to be seen as a valid trust. After investigating the AE Trust Deed, it is clear that the AE Trust fulfil the requirements to be registered as a valid trust.

Chapter four will investigate the tax consequences of share trusts in general and will critically analyse certain transactions taking place in trusts, whilst investigating the application thereof in the AE Trust.

CHAPTER 4

TAX CONSEQUENCES OF EMPLOYEE SHARE SCHEMES

4.1 INTRODUCTION

In order to investigate the AE Trust's tax situation, a critical analysis should be done of all taxable events arising in a trust.

Section 25B of the Income Tax Act 58 of 1962 deals with the tax consequences of a trust, and the different events leading to tax obligations. The type of right that a beneficiary has to income in the trust will determine who will be taxed on that income. Section 25B states that where a beneficiary has a vested right in income that accrues to the trust, the beneficiary will be taxed on that income. The trust will be taxed on all income that accrues to the trust in which beneficiaries do not have a vested right. Should the trustees exercise their discretionary right to distribute income to the beneficiaries, the beneficiaries will be taxed on the income received (SAICA, 2010:150). Currently trusts are taxed at forty per cent. A trust will not receive any rebates or discounts for income tax purposes, as a trust is not deemed to be a natural person.

Section 25B is still subject to the provisions of Section 7 of the Income Tax Act no 58 of 1962. Section 7 specifically deals with situations where certain types of donations were made to the trust which in certain instances will be taxed in the hands of the person making the donation.

In *CIR v Rosen (1971 A)* it was held that income distributed to beneficiaries will only retain its identity if it is distributed in the same year of assessment that the trust has received it. Should the income be distributed in a following year of assessment, the income will loose its identity, and the income distributed to the beneficiary will be specifically included in the beneficiary's taxable income for the year of assessment (Stark, 2010:803).

Different sections of the Income Tax Act 58 of 1962 will now be discussed.

4.2 SECTION 8 OF THE INCOME TAX ACT NO 58 OF 1962

An employee that acquires shares from his/her employer for a consideration less than the market value of the shares or for no consideration at all will be taxed on the fringe benefit received (Van Schalkwyk, 2010:361). Section 8 of the Income Tax Act no 58 of 1962 specifically addresses these benefits and the taxation thereof.

4.2.1 Section 8A

Before 26 October 2004 Section 8A of the Income Tax Act No 58 of 1962 applied to any **share options** or rights acquired before 26 October 2004. Any gains made by a director or employee by exercising, releasing or session, in whole or partially, a right to acquire a share must be included in that employees gross income. This inclusion will be applicable if the right to the share was obtained because of the employee's employment in that specific company. The employee is considered to have made a gain if the market value of the right at the time of exercising the right exceeds the value that he/she paid for the right. The employee can elect to defer the tax payable on the gain to the year of assessment during which he/she is entitled to dispose of his/her saleable security (Van Schalkwyk, 2008a:311-312).

4.2.2 Section 8B (Broad-based employee share plans)

Section 10(1)(nC) of the Income Tax Act 58 of 1962 (SAICA, 2010:68) provides an exemption from normal tax in the form of section 8B.

After 26 October 2004 Section 8B of the Income Tax Act No 58 of 1962 replaced Section 8A with regard to qualifying **equity shares** acquired by employees. Section 8B was originally introduced to decrease the tax burden on employees that received shares through a broad-based employee share plan. The market value of each share is calculated on the day that the share is awarded to the employee. To qualify for the tax relief, the market value of the equity shares is not allowed to exceed fifty thousand rand over a five-year period. The tax exemption provided to the employee under section 8B will not be available should the market value of the shares exceed fifty thousand rand over a five year period, and will the employee be taxed on the difference between the market value of the shares and the consideration thereof paid by the employee.

Should an employee disposes of any qualifying equity share within five years of receiving the equity share, the gain made by a person from the disposal of the qualifying equity share is included in the employee's taxable income. If the employee disposes of the qualifying equity shares after five years, the gain will be taxed as a capital gain and capital gains tax will arise (Van Schalkwyk, 2008a:313).

The purpose of section 8B is to encourage participation by the employees of the company and must comply with the following regulations:

- at least eighty per cent of the employees that are permanently employed by the company should participate in the employee share scheme;
- the employer must provide the shares to the employee for no or little reimbursement;
- the employees that receive equity shares are entitled to the full dividend and voting rights with regard to the equity shares; and
- there is no limit to the receipt of the equity shares, except for:
  - limits imposed by legislation;
  - the right of any person to obtain the equity shares from the employee or former employee at market value on that date;
  - the right of the company to obtain the equity shares from the employee or former employee at the market value on the date of allotment if the employee was found guilty of misconduct or poor performance; or
  - a limit that the employee or former employee may not sell the equity shares within a period that may not exceed five years from the date of the allotment of the equity shares (Van Schalkwyk, 2010:362)

When looking at the AE Trust deed, it is clear that the AE Trust does not comply with the requirements to be classified as a broad-based employee share plan. Section 8B requires that at least 80 per cent of a company's employees must participate in the share transaction. With XYZ only twelve of the fifty employees are participating in the share transaction. For section 8B to apply, the market value of the shares may also not exceed fifty thousand rand, whilst the market value of XYZ's shares is much higher than that. The employees of XYZ will therefore not receive the tax-relief of section 8B.

4.2.3 Section 8C (The taxation of employees at the vesting of equity instruments)

Section 8C of the Income Tax Act No 58 of 1962 deals with the taxation on the assigning of **equity instruments** in employees after 26 October 2004. The main purpose of section 8C is to postpone the tax liability on limited equity instruments to a date in the future. Specifically included in the definition of equity instruments are:

- an option to acquire a share or part of a share; and
- any financial instrument that is transformable into a share or part of a share. Included in financial instruments are:
  - "loans, advances, debts, stocks, bonds, debentures, bills, shares, promissory notes, banker's acceptances, negotiable certificates of deposit, deposits with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument;
  - any repurchase or resale agreement, forward purchases agreement, forward sale agreement, futures contract, option contract or swop contract; and
  - any other contractual right or obligation the value of which is determined directly or indirectly with reference to a debt security or equity, any commodity as quoted on an exchange or rate index or a specified index." (Spamer, 2008).

Over the years, a number of share option plans have been developed to allow management to obtain shares for a relatively low or no consideration. Share options, deferred delivery shares, restricted shares and convertible debentures are included. Any equity or instrument that resides in an employee of a company is taxed upon vesting in that employee. To determine when an instrument vests, one has to determine whether the instrument is restricted or unrestricted. A restricted instrument can consist of one or some of the following restrictions:

- restrictions upon disposal (there is a time-frame on the disposal);
- restrictions to forfeit (if the employee can be penalised for not complying with the terms of the agreement);

- rights to impose restrictions on the disposal of the instrument;
- options on restricted equity instruments (the option is a restricted instrument if the equity instrument that it can acquire is a restricted instrument);
- financial instruments that can be converted into restricted equity instruments;
- certain employee escape or cancellation clauses; and
- if the vesting of the instrument in an employee is dependent on a specific event (Van Schalkwyk, 2008a:315).

An unrestricted instrument will vest when the employee acquires the instrument and the gain made will be included in the employee's taxable income. Subsequently the employee can also deduct any losses made by the instrument from his/her taxable income.

A restricted instrument will vest at the earliest of the following events:

- when all restrictions terminate;
- immediately before the employee disposes of the restricted instrument;
- immediately after an option that qualifies as a restricted equity instrument terminates;
- immediately before the death of the employee, if all restrictions are lifted at that time; and
- when an employee forfeits an equity instrument (Arendse, 2007:15-16).

The gain (difference between the market value of the equity instrument and the consideration paid by the employee for that instrument) made upon vesting will be included in the taxable income of that employee (Arendse 2007:15-16), and the employer is responsible to deduct the appropriate employees tax through the payroll.

According to Arendse (2007:15-16) it is important to note that Section 8C applies when the shares are required from **any person by arrangement with his/her employer**. Even when shares are obtained through a third person, the tax consequences of Section 8C will still apply.

4.3 TAX CONSEQUENCES OF SPECIFIC TRANSACTIONS IN AN EMPLOYEE SHARE TRUST

Different transactions in the employee share trust will have different tax consequences.

4.3.1 Donations Tax

Section 54 of the Income Tax Act 58 of 1962 states that donations tax is payable when a South African resident (including a company) donates something of value to another person (or trust), and is levied at a rate of twenty per cent. This tax rate is applicable to all donations made after 1 October 2001. According to section 55(3) the donation will be qualify as a valid donation when all the lawful regulations to qualify a donation as a valid donation have been fulfilled.

Section 56 deals with certain instances where donations might be exempt from donations tax. Section 56(2)(a) deals specifically with the exemption that a company receives when making a donation. Currently this exemption is ten thousand rand per year of assessment (Oosthuizen, 2010:789). Section 56(2)(b) deals with the exemption of donations tax for natural persons. The exemption for a natural person is currently set at one hundred thousand rand per year of assessment (Oosthuizen, 2010:790)

Section 58 makes provision for circumstances where section 8C can be seen as a deemed donation. The purpose of section 8C is to postpone the tax liability of restricted equity instruments to a date in the future when the profit on the restricted equity instruments can be taxed at normal tax rates. According to Oosthuizen (2010:788) taxpayers may try to avoid the donation in order to prevent paying tax on it. One of the ways to avoid section 8C is to sell the restricted equity instruments to a connected person or through a transaction that is not an arms length transaction before the restricted equity instrument(s) vests in the taxpayer (section 8C(5)). Section 58(2) will deem this kind of transaction to be a donation. The value of the donation will be calculated by subtracting the remuneration received for the restricted equity instruments from the rational market value thereof.

Certain transactions in a trust are seen as donations and might lead to a donations tax obligation:

- The company donates the amount needed to pay for the shares, to the employee share trust:
    - The amount donated to the trust will attract donations tax at 20 per cent. Depending on the value of the shares, the donations tax may be a considerable amount (section 7(2) of the Income Tax Act (Stark, 2010:806)). In this particular case study, XYZ's cash flow situation may be severely impacted when adding the value of the donation and the donation's tax together.
- The company loans the money needed to pay for the shares to the employee share trust through an interest-free or low interest rate loan:
    - When a person loans money to a trust, the difference between the interest that should have been paid and the interest actually paid will be seen as a donation according to section 7 of the Income Tax Act. This is considered to be a donation in the hands of the company, and 20 per cent donations tax will be payable by the company. Depending on the value of the loan, the donations tax may be a considerable amount. In *CSARS v Woulidge* (2002(2) SA 199(A)) it was held that the *in duplum* rule, that prevents the accumulation of interest when the interest amount exceeds the amount of the outstanding loan, does not apply to section 7. Interest free loans to a trust will normally not give rise to tax consequences for the trust itself, but to the person giving the donation. In this case study, the donation from XYZ to the employee share trust is therefore not limited to the outstanding loan amount (Stark, 2008:693).
- The founder donates the shares to the trust at no consideration:
    - This will activate section 7 of the Income Tax Act 58 of 1962 and donations tax will be paid on the related market value of the shares. Paragraph 18 of the AE Trust Deed states that:

        > "In the event of the founder being assessed for taxes in respect of any income derived by or accrued to the trustees, the trustees shall out of the income of the trust pay the tax assessed and if the founder shall have paid the taxes, the amount thereof shall be a debt due to the

founder. The taxes assessed shall mean the difference between the taxes assessed on the founder's income including such income referred to immediately above, and the taxes which would have been assessed excluding such income."

The AE Trust Deed specifically refer to "**income** derived or accrued to the trustees" and not a tax arising from a donation. The founder would therefore not be able to claim the twenty per cent donations tax back from the trust. The trust may also not necessarily have the funds to pay for the donations tax. If the AE Trust only borrows enough money to pay for the shares there will not be sufficient funds available to pay for the donations tax as well.

Oosthuizen (2010:787) states that it is currently not the Receiver of Revenue's practice to deem interest-free loans as donations, even though the current legislation allows the Receiver of Revenue to do so.

When looking at the AE Trust, it is clear that the Receiver of Revenue have the right to tax the trust on the interest-free loan that it has received from XYZ. The current legislation also allows the Receiver of Revenue to levy donations tax on the interest-free loan. Although it is not currently the Receiver's practice to levy donations tax on interest-free loans, this may become an issue in the future.

4.3.2 <u>Avoiding donations tax on the interest-free loan</u>

To avoid paying donations tax on the interest-free loan, XYZ can issue a special class of shares to the AE Trust, which will have a value of 1c each. The value of the shares of 1c each will not be market related. The difference between the market value of the shares and the value of 1c will deemed to be a loan. This will be hypothetical cash flow. Should the loan not be paid back the same day, SARS may deem it to be an interest-free loan. As per section 7 of the Income tax Act No 58 of 1962, the interest may be seen as a donation to the trust, and XYZ have to pay twenty per cent donations tax on it. However, should XYZ declare a dividend for the special class of shares that was issued to the AE Trust on the same day that the shares are issued, for a value equal to the loan value, and the AE Trust use this dividend on the same day to repay the loan to XYZ, there will be no interest on the loan and as a result no deemed donation to the Trust. This will also be hypothetical cash flow. This will only apply if the dividend is declared on the same day that the shares are issued. XYZ will still have to pay Secondary Tax on Companies of ten per cent on the value of the dividend. Should the dividend be declared at a later stage, the donations tax of twenty per cent will still apply to the interest-free loan. The company's cash flow situation will have to be considered – the twenty per cent donations tax on the interest of the loan may be cheaper initially than paying ten per cent Secondary Tax on Companies on the dividend. This was confirmed in Binding Private Ruling 103 on 20 May 2011 by the Receiver of Revenue.

In considering any changes to the Income Tax Act that would result in the reduction of tax for employee share schemes, the Receiver of Revenue would have to consider if it is fair to give preferential tax breaks to employees borrowing money from their employer to purchase shares as opposed to employees that borrow money from their employer to purchase a home (Katz Commission: 1997).

4.3.3 <u>Non-deductibility of interest for Income Tax purposes</u>

Section 24J(2) of the Income Tax Act no 58 of 1962 states that when any person borrows money from another person, and the borrower undertake to pay interest to the financier for a period of more than twelve months, the interest incurred by the borrower must be deducted from the borrower's income for the year of assessment, provided that the amount borrowed was used in the production of income for the borrower. Should the money borrowed not be used in the production of income, the interest paid on the loan can not be deducted from the borrower's taxable income for the year of assessment.

Should a company have to borrow money from a bank or similar financial institution to loan or donate the money to an employee share trust, the interest on that loan will not be deductible for income tax purposes, as the loan was not incurred in order to produce income for the company. In *CIR v G Brollo Properties (Pty) Ltd (1994)* the Supreme Court of Appeal held that:

> "In a case concerning the deductibility or otherwise interest payable on money borrowed, the enquiry relates primarily to the purpose for which the

> money was borrowed. That is often the 'dominant' or 'vital' enquiry, although the ultimate user of the borrowed money may sometimes be a relevant factor. Where a taxpayer's purpose in borrowing money upon which it pays interest is to obtain the means of earning income, the interest paid on the money so borrowed is prima facie an expenditure incurred in the production of income… If on the other hand the purpose of the borrowing was for some other purpose than obtaining the means of earning income (e.g. to pay a dividend) the interest is not deductible."

This court case would not just apply when money is borrowed to assist the payment of dividends, but will also apply when money is borrowed by the company to loan or donate the money to the trust to assist the trust to purchase shares. Should XYZ have to borrow money from a financial institution in order to assist the trust to obtain the shares, the interest on the loan will not be deductible from XYZ's taxable income.

4.3.4 <u>Declaring dividends to the trust - secondary tax on companies or Dividend Tax</u>

When a company declares a dividend, tax must be paid. Currently South Africa is still using secondary tax on companies, but this is slowly being phased out and will be replaced on 1 April 2012 by a dividend withholding tax. Currently there are three types of tax involved:

- *Secondary tax on companies:*

  When a company shares its profits with its shareholders, a dividend needs to be declared by the company. This will activate secondary tax on companies at a rate of ten per cent of the net amount of the dividend declared (section 64B of the Income Tax Act). The company declaring the dividend is responsible for paying the secondary tax on companies. Section 64C is an anti-avoidance provision that aims to prevent companies avoiding secondary tax on companies where companies provide advantages to its shareholders without declaring a dividend. There are eight events that will lead to the activation of section 64C:

- cash is paid to or for the benefit of a shareholder or any connected person in relation to that shareholder;
- the company loans money to a shareholder or a connected person in relation to that shareholder;
- when the shareholder, or a connected person in relation to that shareholder is released of an obligation towards the company;
- the company repays debt owed by the shareholder, or a connected person in relation to a shareholder, to a third party, on behalf of that shareholder;
- any amount used by the company to the advantage of a shareholder or connected person in relation to that shareholder;
- a transaction between the company and a shareholder of that company or a connected person in relation to that shareholder, which is not an arms-length transaction and does not take place at the related market value of such a transaction;
- any profits or reserves of a company before the company cease to be a resident of South Africa; will be deemed to be a dividend declared to that company's shareholders; and
- any amount paid by the company in respect of a hybrid instrument as described in section 8F of the Income Tax Act 58 of 1962 (De Swardt, 2010:552).

In the majority judgement of *CSARS v Airworld CC (2007)* Judge AJA Hurt held that the interest-free loan made by the company to the trust, should be deemed as a dividend and secondary tax on companies levied at ten per cent should be paid.

- *New dividend withholding tax:*

The Minister of Finance announced in 2007 that a new dividend tax will replace the current secondary tax on companies system. The implementation date of the new dividend withholding tax is currently set for 1 April 2012. Section 64E(1) of the Income Tax Act stipulates that the shareholder instead of the company will be taxed on the dividend received. The company will be responsible for withholding the dividend tax from the shareholder (deduct it from the dividend payable) and pay it over to the Receiver of Revenue. The new dividend tax will therefore be a withholding tax on a shareholder and not a secondary tax on a company (De Swardt, 2010:560).

- *Value extraction tax:*

  Similar to the deemed dividend provisions of section 64C, value extraction tax prevents the withdrawal of value from a company where the company is not declaring a dividend. When the new dividend withholding tax comes into effect on 1st April 2012, section 64P of the Income Tax Act may be activated under certain circumstances. Section 64P(2) states these circumstances as:

  - if the company provides financial assistance during a financial year to a person that is a connected person in relation to the company (the amount of the value extraction will be the difference between the market-related interest with regard to the financial assistance, and the interest payable by the particular connected person) ;
  - if the company discharges a connected person in relation to the company from any monies due to the company (the amount of the value extraction will be the value of the discharge);
  - if the company reimburses a third party on behalf of a connected person (the amount of the value extraction will be the amount that was paid by the company and not repaid by the connected person); or
  - if a company cease to be a resident of South Africa for tax purposes (the amount of the value extraction will be the market value of all the assets of the company less the liabilities of the company when the company ceases to be a resident).

Certain transactions will not initiate value extraction tax (Section 64Q(2) of the Income Tax Act):

- if financial assistance is provided to the connected person for the facility of inventory or services in the normal trade of the business as conducted by the company; or
- if the company is a money lending business and the financial support is part of the company's normal business activities; or

- if the financial aid provided by the company to a trust, to enable the trust to purchase shares in that company or any other company in the same group of companies, on condition that the disposal of those shares by the trust are to employees, under a share incentive scheme operated by the business, to the advantage of those employees.

The loan from XYZ to the employee share trust will therefore not initiate value extraction tax as it complies with the provision of section 64Q(2(c)).

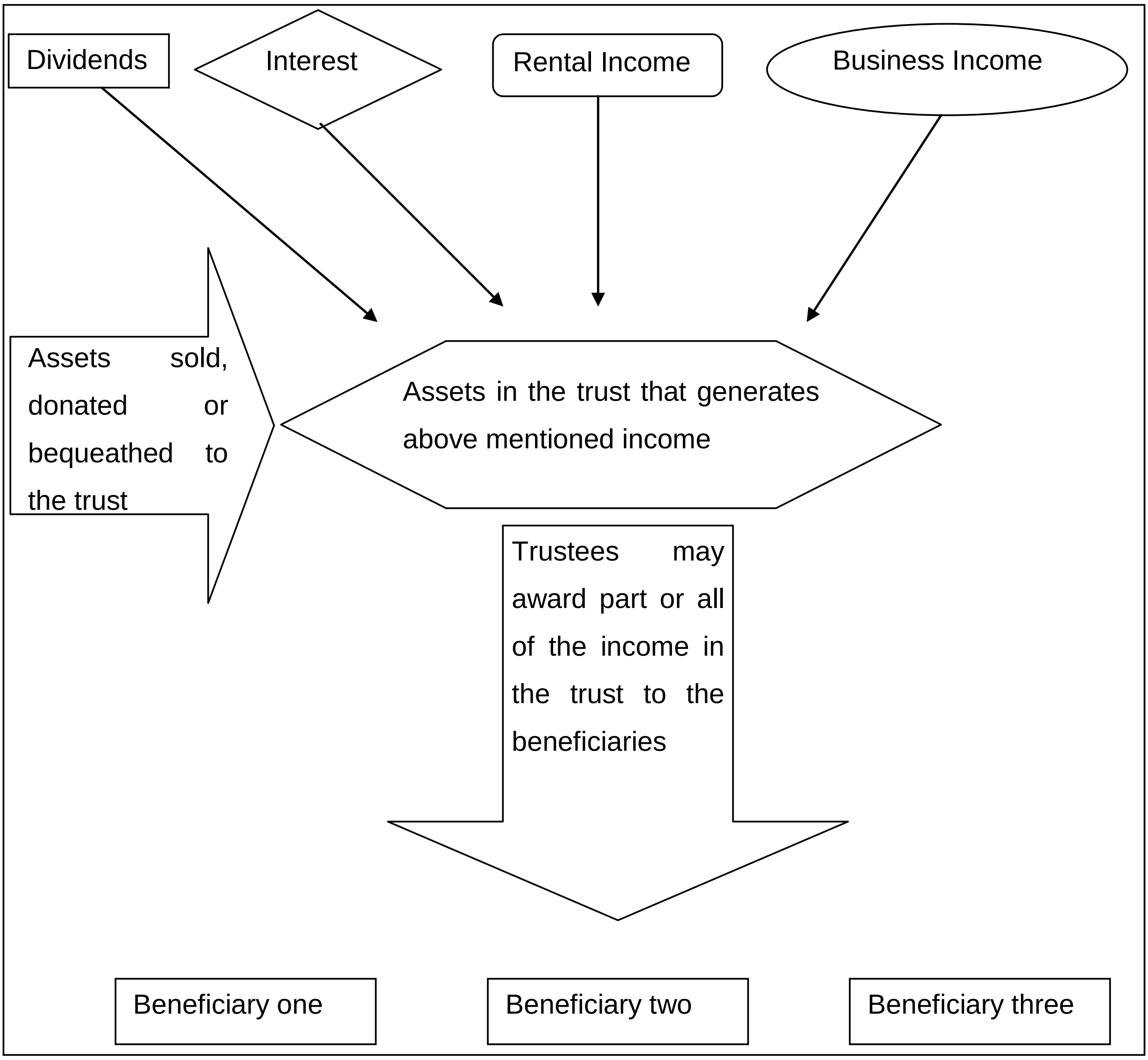
The dividends received from XYZ will attract tax. Currently the dividends received from XYZ will attract Secondary Tax on Companies, which is paid by XYZ. When the new dividends tax comes into effect, the dividends will attract a dividend withholding tax. XYZ will withhold the tax on behalf of the beneficiaries of the trust, and pay the taxes withheld to the Receiver of Revenue.

4.3.5 <u>Revenue distribution to the beneficiaries of the trust</u>

Section 25B of the Income Tax Act 58 of 1962 states that income is deemed to have accrued to a beneficiary should the beneficiary have a vested right to that income (Edward Nathan Sonnenbergs Inc., 2007). The source and type of income that the trust receives determine the tax treatment thereof in the trust (Stark, 2010:802). Trusts are conduits for passing income and capital to beneficiaries whilst trying to minimise the tax liability thereof. The Supreme Court of Appeal held in 1938 in *Armstrong v CIR* (1938AD) that trust income will retain its identity until it reaches the hands of the beneficiaries of the trust, as illustrated in Figure 1. A trust is merely a conduit to pass income on to beneficiaries, and the income retains its identity until it reaches the beneficiaries. Trust income does not merely loose its identity because it first had to pass through the trust.

Figure 1 explains the conduit principle

Figure 1: The conduit principle



Source: Stark (2010:802)

Edward Nathan Sonnenbergs Inc. (2007) states that problems may arise where an asset is held by a trust whilst a beneficiary has a vested right in the income that accrues to that particular asset. Certain exemptions in the Income Tax Act 58 of 1962 links the exemption available to that particular asset to the holder of the asset, which in most cases will be the trust. Most trusts operate on the rule that the assets are owned by the trust and that the income vests in the beneficiaries.

If there are any exemptions available as per the Income Tax Act 58 of 1962 to the type of income received by individuals, it will still be available when the same type of income is distributed to the beneficiaries of a trust, since income in a trust retains its nature. Table 1 refer to the relevant section of the Income Tax Act.

The following sections refer to the exemptions available for types of income received:

Table 1: Exemptions available for income received by beneficiaries

Types of income	**Relevant section of the Income Tax Act 58 of 1962**
Local interest income	Section 10(1)(i)(xv)
Foreign interest income	Section 10(1)(i)(xv)(aa) limited to R3700
Local dividend income	Section 10(1)(k)
Foreign dividend income	Section 10(1)(i)(xv)(aa) limited to R3700

Source: Stark (2010:802)

The conduit principle also requires that income is distributed pro rata from all types of income in a trust, unless specifically stated otherwise in the trust deed.

In the case of the AE Trust, income will retain its identity until it is distributed to the employees. Any dividend income that the AE Trust receives from XYZ will still be treated as dividend income in the hands of the employees, provided that it is distributed to the employees in the same year of assessment (*SIR v Rosen* (1971 A)). Dividend income distributed to the employees will therefore be tax free, as XYZ will be paying the Secondary Tax on Companies. This will however change when the new dividend-withholding tax comes into effect. The employees will be taxed on the dividend, but XYZ will withhold the tax before the dividend is distributed to the AE Trust.

4.3.6 Vesting of shares in a beneficiary of a trust

As mentioned in paragraph 3.5, beneficiaries have two types of rights in a trust. When deciding who is responsible for paying the tax on trust income, it is clear that Section 7 of the Income Tax Act No 58 of 1962 deals with four types of rights:

- Vested right: The beneficiary is entitled to certain assets and the income generated by that those assets held in a trust. In such cases the trustees will only manage the asset and its income on behalf of the beneficiary. Beneficiaries with a vested right to trust assets and trust income will be responsible for paying the tax thereon, even if they have not physically received the revenue therefore.
- Discretionary right: Depending on the discretion of the trustees, a beneficiary may become entitled to some income / capital in a trust. The trust will be taxed for any income derived if the revenue has not been distributed to the beneficiaries of the trust.
- Conditional right: The beneficiary has to comply with certain conditions set by the trustees, the trust deed, the founder of the trust, or the person making the donation, before he/she will receive a vested right to income. The trust will be taxed for any income derived if the revenue has not been distributed to the beneficiaries of the trust.
- Revocable right: The person making the donation has the right to recall a beneficiary's right to assets in a trust, or to transfer that right to another beneficiary. The donor will be taxed for any revenue received, even if the revenue has been distributed to the beneficiary.

A vested right is certain, whilst a contingent or discretionary right is conditional, depending on the discretion of the trustees.

Vested rights can have different meanings in different circumstances. Judge JA Watermeyer stated in *Jewish Colonial Trust Ltd v Estate Nathan* that the word 'vest' accepts different meanings depending on the context in which it was used.

> "When it is said that a right is vested in a person, what is usually meant is that such a person is the owner of that right – that he had all rights of ownership in such right including the right of enjoyment. If the word 'vested' were always used in that sense, then to say that a man owned a vested right would mean no more than a man owned a right. But the word is also used in another sense, to draw a distinction between what is certain and what is conditional; a vested right as distinguished from contingent or conditional right. When the word 'vested' is used in this sense…in reality a right of one class is not being distinguished from a right of another class

> but that a right is being distinguished from a chance or possibility of a right, but it is convenient to use the well-known expressions vested right and conditional or contingent right."

Judge J Milne pointed out in *ITC 1328* (1980:60) that a vested right may vest in a beneficiary, even though the enjoyment of the asset may only take place sometime in the future after the trustees have exercised their discretionary right. It is also not necessarily as a result of vesting that the beneficiary of the trust has a lawful right to claim payment (South African Revenue Service, 2010:465-466).

In *ITC 76* (1927:69) the court pointed out that a vested right must be something substantial that could be measured in money and that had a present value, whilst a conditional right is a right which may or may not realize. A conditional right can therefore never have a value as opposed to a vested right.

Once a beneficiary has a vested right in income from a trust, he/she will be taxed on that income, regardless whether he/she has received the income or not.

Section 7(5) of the Income Tax Act No 58 of 1962 (SAICA 2010) deals with conditional vesting in beneficiaries. There has to be a donation to the trust subject to the fulfilment of certain conditions before section 7(5) will apply. The beneficiary will not receive a vested right to trust assets unless certain conditions have been complied with, or a certain event has taken place. If section 7(5) applies, the person making the donation will be taxed on the revenue, until the beneficiary has received a vested right in the asset.

Section 7(6) of the Income Tax Act No 58 of 1962 (SAICA: 2010) deals with the taxation issues where a beneficiary has a revocable right in trust income and/or assets. This section will apply where the person making the donation has the option to withdraw a beneficiary's right or to transfer that right to another beneficiary in the trust. In this case the person making the donation will be taxed on the income generated by such a donation, even though the income has already been paid to the beneficiary with the revocable right. Section 7(6) will only apply where the person making the donation has the right to withdraw the beneficiary's right and not when trustees have the right to withdraw the beneficiary's right.

When examining the AE Trust deed, it states as follows: "All property acquired by the trustees in their capacity as such shall vest in the trustees to be administered and disposed of according to the provisions of this trust deed for the benefit of the beneficiaries." The trust deed also further states that trustees can "… pay any beneficiary any amount due to the beneficiary ... with the power in their absolute discretion to determine the selection and valuation of any assets to be distributed and the manner of distribution thereof among beneficiaries…" It is clear that the beneficiaries have a discretionary right in the trust, and that the assets vest in the trustees as opposed to vest in the beneficiaries. As a result the beneficiaries will only be taxed on the trust revenue that was distributed to them. Any revenue remaining in the trust after the year of assessment has been completed will be taxed in the trust.

Paragraph 18.2 of the trust deed states that: "Further it is specifically placed on record that the trust will only act on the conduit principal and the trust will not be responsible for any taxes, while all taxes will be taxed in the hands of the beneficiaries." Even though the trust deed states that the trust will not be responsible for paying taxes on revenue received, this still only pertains to revenue that was distributed to the beneficiaries. Any revenue remaining in the trust at end of the year of assessment will be taxed in the hands of the trust.

4.3.7 Capital gains tax consequences

Capital gains tax came into effect in South Africa on 1 October 2001. When disposing of an asset, it has to be established if the profit or loss rising from the establishment is of a revenue or capital nature. If the profit is of a revenue nature, the full profit must be included in the taxpayer's taxable income for the year of assessment. If the profit is of a capital nature, capital gains tax will be activated. The rules and requirements for capital gains tax is contained in the eighth schedule of the Income Tax Act 58 of 1962 (Koekemoer, 2010:829). Capital gains are currently taxed at a lower tax rate than gains of a revenue nature.

Only assets disposed of on or after 1 October 2001 will be included in the capital gains tax calculation. If a taxpayer owned assets before 1 October 2001, but disposed of the asset only after 1 October 2001, the value of the asset as at 1 October 2001 will be used to calculate the basis cost of the asset.

The South African Revenue Service has issued a "Comprehensive guide to capital gains tax issue three" which explains capital gains tax in detail. When establishing if a profit or a loss is of revenue or a capital nature, it is important to establish the taxpayer's intention when acquiring the asset. Judge JA Wessels held in *CIR v Stott* (that the taxpayers intention when acquiring the asset is decisive in establishing the nature of the receipt rising from the disposal of the asset, unless other evidence exist to support that the asset was disposed in a scheme to make a profit. However, it is possible that a taxpayer's intention could have changed with regard to the asset. Judge JA Wessels held in John Bell & Co (Pty) Ltd v SIR (1976) that the change in purpose to get rid of an asset, which until the date of disposal was held as capital, does not necessarily all of a sudden activate income tax rules as opposed to capital gains tax rules. Other factors are required, such as the nature of the taxpayer's business, the start of a new business, or when the taxpayer starts selling similar assets for a profit. The assets in question must be held as the taxpayer's trading stock in order for the profit to qualify as profit of a revenue nature (South African Revenue Service, 2010:44).

In *Burmah Steamship Co Ltd v IRC* it was held that the 'filling a hole' test should be applied when investigating compensation received. It must be established if the compensation was intended to fill a hole in the taxpayer's profits, or to fill a hole in the taxpayer's assets. If the intention was to fill a hole in the taxpayer's profits, the compensation will be of a revenue nature, as opposed to a capital nature when filling a hole in the taxpayer's assets (South African Revenue Service, 2010:47).

When looking at the disposal of shares, one also has to establish if the profit made from the sale is of a capital or a revenue nature.

- As held in *Barnato Holdings Ltd v SIR*, the usual characteristics of a fixed capital investment is that it is attained with the intention to keep it for a long time and will only be disposed of under some unusual and unforeseen event.

- In *CIR v Middelman (1991)* it was held that the occasional sale of shares for a profit does not necessarily make the seller a share-dealer. Each transaction has to be assessed on its own merits.
- Shares mainly bought to yield the highest possible dividend return, does not necessarily constitute share trading. The profit made when selling the shares will be seen as capital if the profit was made unintentionally.
- When the foremost intention of the shareholder is to receive dividends, but the subordinate intention is to make a profit when selling the shares, the sale will be treated as having a revenue nature.
- In *CIR v Nussbaum (1996)* it was held that the regularity with which a shareholder sells his/her shares is important, but does not necessarily make him/her a share-dealer (South African Revenue Service, 2010:52-53).

The following components are needed in order to calculate capital gains tax:

- there has to be an asset, whether moving or not moving, real or incorporeal; or a right or interest in the asset; and
- the asset must be disposed of or deemed to be disposed of. Paragraph 11(1) of the Eighth Schedule of the Income Tax Act no 58 of 1962 lists disposals as:
  - the sale or donation of any asset or the handover of the rights to an asset (paragraph 11(1)(a)); or
  - the loss, dissolution, release or relinquishment of any asset (paragraph 11(1)(b)); or
  - the scrapping or termination of an asset (paragraph 11(1)(c)); or
  - the vesting of an interest in a trust asset in a beneficiary (paragraph 11(1)(d)); or
  - the distribution of an asset to a shareholder (paragraph 11(1)(e)); or
  - the exercise of an option (paragraph 11(1)(f)); or
  - the decline of value of a person's share in a company as a result of a value shifting agreement (paragraph 11(1)(g)) (SAICA, 2010:295).

  Deemed disposals include the following:
  - a person stops being a resident for tax purposes (paragraph 12(2)(a)); or
  - where assets are not held as trading stock any more (paragraph 12(3)); or

  - where a controlled foreign company becomes a resident for tax purposes (paragraph 12(4)); or
  - where a debt owed to a creditor has been discharged or reduced by the creditor (paragraph 12(5)) (SAICA, 2010:296).
- The time of the disposal as specified in paragraph 13 of the Eighth Schedule (SAICA, 2010:297):
  - an agreement where the disposal of the asset is subject to a condition being fulfilled (paragraph 13(1)(a)(i)) – the time of disposal will be the date on which the condition is fulfilled
  - an agreement that is not subject to a condition being fulfilled (paragraph 13(1)(a)(ii)) – the time of disposal will be the date on which the agreement is concluded
  - distribution of an asset to a person with a vested right (paragraph 13(1)(a)(iiA)) – the time of disposal will be the date on which the right vested
  - the donation of an asset (paragraph 13(1)(a)(iii) – the time of disposal will the date on which all the legal requirements to be a valid donation has been fulfilled
  - the dispossession of an asset (paragraph 13(1)(a)(iv)) – the time of disposal will be the date on which the person receives the full reimbursement as agreed to
  - the conversion of an asset (paragraph 13(1)(a)(v)) – the time of disposal will be the date on which the asset is converted
  - the granting, renewal or extension of an option (paragraph (1)(a)(vi)) – the time of disposal will be the date on which the option is granted, renewed or extended
  - the use of an option (paragraph 1(a)(vii)) – the time of disposal will be the date on which the option is used
  - the cessation of an option to acquire shares in a company (paragraph 1(a)(vii)) – the time of disposal will be the date on which the option is ended
  - in any other case, the date of change of ownership (paragraph 1(a)(ix)).
- The base cost must be calculated (paragraph 20). The base cost of an asset can be calculated as follows (SAICA, 2010:299):

- if the asset was obtained before 1 October 2001, the base cost will deemed to be the value of the asset on 1 October 2001, plus any costs incurred after 1 October 2001
- if the asset was obtained after 1 October 2001, the base cost will deemed to be the cost incurred to obtain the asset.

Included in the base cost is the following:

- any costs incurred to obtain the asset (paragraph 20(1)(a));
- any costs incurred to obtain a valuation for the asset (if the valuation of the asset was done for capital profit or loss purposes) (paragraph 20(1)(b));
- the remuneration services delivered by a surveyor, accountant, lawyer with regard to the asset (paragraph 20(1)(c)(i));
- transfer fees payable (paragraph 20 (1)(c)(ii));
- transfer duty and stamp duty (paragraph 20 (1)(c)(iii));
- costs incurred to advertise the asset (paragraph 20 (1)(c)(iv));
- costs incurred to relocate the asset (paragraph 20 (1)(c)(v));
- installation cost of the asset (paragraph 20 (1)(c)(vi));
- donations tax payable due to the donation of that asset (paragraph 20 (1)(c)(vii));
- the costs incurred by the exercising of an option to obtain that asset (paragraph 20 (1)(c)(ix));
- certain legal fees (paragraph 20 (1)(d));
- the costs incurred to improve the asset, if the improvement is still visible at the time of disposal of the asset (paragraph 20 (1)(e));
- one third of costs incurred to own assets which is exclusively used for business purposes; or shares listed on a recognised stock exchange, provided that the costs are not deductible for normal income tax purposes (paragraph 20 (1)(g));
- where an asset is inherited by a resident from a non-resident, the base cost will be the market value of the asset at the time of death (Koekemoer, 2010:845); and
- where an asset is donated by a non-resident to a resident, the base cost will be the market value of the asset at the time of the donation (Koekemoer, 2010:845).

Paragraph 19 of the Eighth Schedule of the Income Tax Act no 58 of 1962 deals with losses made on the disposal of certain shares. When a person disposes of his shares in a company, that person must ignore so much of any capital loss that arises as a result of the disposal that does not exceed any extraordinary dividends accrued to that person in respect of those shares for a two year period, regardless if the disposal was done in part. Therefore, if a person extracts a dividend from a company and then sell the shares in that same company at a loss, that arises as a result of the dividend extraction, such capital loss that exceeds the extraordinary dividend received, may not be deducted for capital gains purposes (SAICA, 2010:298).

Vesting of an asset in a beneficiary is seen as a disposal of trust assets by the 8th Schedule of the Income Tax Act (Section 11(1)(d)). Section 25B(2) of the Income Tax Act Nr 58 of 1962 states that where a beneficiary has received a vested right in a trust asset, any amount derived as a result of the vesting will be seen as a benefit of that beneficiary and the beneficiary will subsequently be taxed on it (SAICA, 2010:150).

Section 9C of the Income Tax Act no 58 of 1962 establishes that qualifying equity shares must be held for at least three years by the tax payer, in order for the disposal of the shares to qualify as a capital disposal, therefore activating the calculation of capital gains tax instead of income tax (SAICA, 2010:50).

Rights to trust assets will vest in a beneficiary when the beneficiary has an unconditional right to that particular asset (Stark, 2010:816), even though the date on which the beneficiary may enjoy the benefit is some time in the future. Vesting can take place before the endowment of the asset. The value of the vesting is calculated on the date that the asset vests in the beneficiary at a market related value. The base cost of the asset is the value of the asset at the date that the trust received the asset. The difference between these two values will give rise to Capital Gains Tax (Stark, 2010:816).

Natural persons qualify for an annual exclusion of R17,500 when calculating capital gains (Koekemoer, 2010:832). The unused portion of the annual exclusion can not be carried over to the next year of assessment. Twenty five per cent of the individuals' capital gains (after the annual exclusion has been deducted) must be included in the individual's taxable income for the year. This will have an effective capital gains tax rate of ten per cent (twenty five per cent x forty per cent (maximum marginal tax rate for individuals)).

The rights to the shares will vest in an XYZ employee once the employee has been in XYZ's employment for five years. According to the Eighth Schedule of the Income Tax Act no 58 of 1962, the vesting of the shares in the employees will be seen as a disposal for capital gains tax purposes. The base cost of the shares will be calculated as the purchase price that the trust has paid for the shares plus any costs incurred by the trust to acquire the shares. The capital gain made upon vesting will be the difference of the market value of the shares upon vesting and the base cost of the shares. Depending on the growth in the market value of the assets, the capital gain included in the employee's taxable income for the year of assessment may be a considerable amount, and may lead to cash flow shortages.

A second capital gain will be triggered when the employee decides to sell the shares. The capital gain will be the difference between the compensation that the employee receives for the shares, and the base cost of the shares on vesting. The employee will be responsible for paying the tax on the capital gain.

4.4 RECENT TAX AMENDMENTS

In the draft amendment bill released for comment on 3 June 2011, certain changes with regard to employee share schemes have been made.

4.4.1 <u>Draft amendment bill released for comment on 3 June 2011 – section 10(1)(k)(i)(dd)</u>

Dividends received as a result of restricted equity instruments (as defined in section 8C) would attract income tax in the hands of the recipient, due to amendments to section 10(1)(k)(i)(dd) of the Income Tax Act no 58 of 1962. This amendment exclude equity shares and came into effect on 1 January 2011.Unfortuantely employee share trusts have to adhere to this as well. Normally trusts are structured in such a way that the trust purchase the shares, and the beneficiaries have vested rights in the revenue derived from those shares, but do not have a right in the shares themselves. This is to prevent the employees from selling the shares in the open market. Section 8C(5)(b) deems that section 8C will apply as if the beneficiary had obtained the shares directly, where restricted equity instruments that were obtained by a person (the trust) other than the participant in the shares (the beneficiary / employee) through his/her employment in a company. As a result, the shares held by the trust will be subject to the provisions of section 8C, and consequently dividends that accrue to the trust as a result of restricted equity instruments will be subject to income. As the conduit principal applies to revenue received in a trust, the beneficiaries receiving the dividends would be receiving the income tax liability as well. Section 25B of the Income Tax Act no 58 of 1962 deems any revenue received by a trust, to the extend that the amount has been received for the benefit of a beneficiary in the trust who has a vested right to that revenue, will accrue directly to that beneficiary. Where the amount received has not been for the benefit of a beneficiary with a vested right to the revenue, the revenue will accrue to the trust. If the dividends were not received relating to the participants vested rights, the dividends would accrue to the trust, and section 10(1)(k)(i)(dd) will apply, resulting in the trust paying income tax on dividends that were previously exempt from income tax (Spamer, 2011:1).

Brincker (2011:1) contends that the current phrasing of the tax legislation has the result that employers and employees participating in employee share schemes will suffer undesirable tax consequences when participating in employee share schemes that are developed to reward employees. Dividends will only be exempt from income tax if the dividend is received as a result of a restricted equity instrument. A dividend will not be exempt from income tax if a beneficiary has vested rights in restricted equity instruments in a trust, and are only allowed to participate in dividends, or have an option to receive shares at a later stage. Any right in a share incentive trust will lead to dividends being included in the taxpayer’s taxable income. In the 2011 budget speech it was indicated that this situation will be reviewed, as this could lead to double taxation since the company and the employee will be taxed. The employer could also use this to pass disguised salary payments as tax free dividends to the employee.

4.4.2 Draft amendment bill released for comment on 3 June 2011 – section 8EA

A trust can appoint a third party to acquire shares at a market-related price on behalf of the trust. The newly proposed section 8AE introduces the concept of 'third-party backed share'. The effect of section 8AE is that any dividend received as a result of such third party backed share will be treated as revenue and will not be exempt from income tax anymore. In order for the dividends in an employee share trust to remain exempt from income tax, the trust would have to relinquish its rights to appoint a third party to acquire shares on behalf of the trust. However, if the third party backed share is issued on or before 12 May 2012, the trust can apply to the South African Revenue Service to approve the transaction. Once the transaction has been approved by the Commissioner dividends received as a result of the approved transaction will be exempt from income tax (Spamer, 2011:2).

4.5 CONCLUSION

From the above it is clear that different types of taxes apply to trusts, specifically income tax and capital gains tax. These taxes apply to the company issuing the shares, the trust acquiring the shares and the beneficiaries of the trust who are also specific types of employees working for the company. Recently proposed legislation has increased the tax burden on a trust, as the trust will not receive dividends tax free anymore. This legislation is currently open for comments from the public.

CHAPTER 5
CONCLUSION

5.1 INTRODUCTION

The purpose of this study is to use a case study approach to critically analyse the AE Trust deed and evaluate if the trust deed firstly conforms to all the requirements to be a valid trust, and secondly if it succeeds in providing the employees of XYZ shares in the company tax free. It is also important to evaluate the trust deed of the AE Trust to ensure that it fulfils all the requirements of the parties involved, and that it complies with the South African Revenue Service's (SARS) regulations for any tax consequences that may result.

5.2 VALID TRUST REQUIREMENTS

In order for a trust to be recognised as a valid trust in South Africa, it has to fulfil certain requirements such as:

- the creator's resolve must be to create a trust;
- the trust deed must create a binding commitment;
- the trust assets must be easy recognisable;
- the trust's purpose must be unmistakeably clarified;
- the trust's purpose must be legitimate; and
- the beneficiaries must be selected. If a trust does not have beneficiaries the trust will cease to exist and the trust assets will be transferred back to the donor thereof.

The AE Trust deed conforms to the abovementioned criteria, and the AE Trust will be seen as a valid trust in South Africa.

5.3 DOES THE AE TRUST FULFIL THE ORIGINAL INTENTION OF MR X AND XYZ?

According to Mr X, the original purpose of Mr X and XYZ was to provide certain employees with shares in XYZ tax free. Chapter 4 investigated each event that triggers tax when dealing with trusts and specifically employee share trusts. However, regardless of the structure of the trust deed, employees are compelled by law to be taxed when receiving benefits from their employer. This includes receiving shares. The following triggers tax in an employee share trust:

- section 8A of the Income Tax Act no 58 of 1962 – section 8A applies to all share options received before 26 October 2004. As the AE Trust was created in 2009, the provisions of section 8A will not apply;
- section 8B of the Income Tax Act no 58 of 1962 – section 8B will reduce the tax burden on the employee only if 80 % of a company's employees participate in the employee share scheme, and of the value of the shares does not exceed fifty thousand rand over a five year period. As the value of the shares in XYZ exceed the fifty thousand rand requirement, and only twenty four per cent of employees participate in the XYZ share scheme, section 8B will not apply to the beneficiaries of the AE Trust;
- section 8C of the Income Tax Act no 58 of 1962 – section 8C deals with equity instruments and will postpone the payment of tax to a date in the future. XYZ's shares will be seen as restricted equity instruments as employees will only receive the shares once they have been employed by the company for more than five years. Employees will also loose any claim that they had regarding those shares if the leave XYZ's employment before the five year period is over;
- donations Tax – donations tax will be paid if either XYZ or Mr X donates the shares to the trust;
- if XYZ should loan the money to pay for the shares from a financial institution, the interest payable on the loan will not be deducted for income tax purposes as the loan was not obtained in the generating of taxable income for the company;
- when XYZ declares dividends, either secondary tax on companies or a dividend withholding tax will be paid;
- when the shares vests in the employees after the five year period has expired, capital gains tax will be paid on the difference between the value of the shares

when it was obtained by the trust, and the market value of the shares on the date of vesting in the employee. This gain will be included in the employee's taxable income for that year of assessment; and

- when the employee(s) eventually decide to sell the shares, capital gains tax will again be paid on the difference between the value of the shares on the date of vesting, and the amount received when selling the shares.

From the above, it is clear that the employee will be taxed on receiving the shares for no consideration.

5.4 OTHER WAYS OF REMUNERATING EMPLOYEES AS AN ALTERNATIVE TO SHARES RECEIVE IN THE BUSINESS

The following incentives can be used to retain employees in a business.

5.4.1 Cash bonuses

The Top Pay Research Group (2003:58-67) has determined that three years is the maximum period of time that a business can expect employees to wait for hard-earned but deferred rewards. For this to offer effective handcuffs to employees, a business would need to create a coinciding structure whereby a new three-year bonus system commences each year.

5.4.2 Phantom share schemes

If a business need to link remuneration to the company's overall performance, a "phantom" share scheme can be implemented. Employees will receive cash bonuses linked to the growth in the value of the company (or its shares) over time The advantages of phantom share schemes are numerous:

It is not necessary to issue actual shares
It is not necessary to create a trust
No disclosure of sensitive or confidential information to employees is necessary
Easy implementation

The company can deduct the bonus paid to the employee for income tax purposes and declare PAYE correctly as the employee's bonus will be administered through the payroll (Strauss and Haroun, 2009:8-9).

The disadvantage of the phantom scheme is that the employee will have to pay income tax on the bonus received.

5.5 CONCLUSION

Since XYZ is providing the AE Trust with an interest-free loan to pay for the shares, the interest that would have been charged is considered to be a donation to the AE trust (*C:SARS v Woulidge* (2002 (2) SA 199 (A))), according to Section 7 of the Income Tax Act No 58 of 1962. According to Oosthuizen (2008:11), donations tax should be levied on the amount at a rate of twenty per cent. It would therefore be prudent to compare the cash flow implications of paying the twenty per cent donations tax to levying interest on the loan to the AE Trust.

After carefully considering the tax consequences of each event in an employee share trust, it is clear that the intention of the trust, Mr X and XYZ is not fulfilled by the AE Trust deed, as it is not possible to provide employees with shares in a business tax free. Unfortunately it is not possible to reward employees and at the same time entice them to stay with the company for long periods of time, without the employee being taxed on the reward. It is still critical for XYZ to retain its employees for as long as possible in order to prevent losing the knowledge of the employees in their specific field, as it is an extremely competitive industry. Even though the trust may not provide the shares to the employees tax free as per the original requirements from XYZ and Mr X, the trust is still a good vehicle to provide the employees with shares in a controlled manor. Providing the employees with shares in XYZ hopefully will entice the employees to stay for maximum periods of time. Should XYZ decide not to go ahead with the trust, other ways of enticing employees to stay with XYZ for long periods of time should be considered, such as cash bonuses and phantom share schemes.

This case study should provide XYZ with answers regarding the tax consequences of each event in the trust, and should assist XYZ in deciding if it is worthwhile continuing with the trust or if other methods to entice employees to stay in the company's employment for as long as possible should be investigated.

5.6 FUTURE RESEARCH

The recent tax amendments in the draft bill released for comment on 3 June 2011 will change the way that tax has been treated in trusts with regards to dividends and dividend income. If the dividends were not received relating to the participants vested rights, the dividends will accrue to the trust and the new section 10(1)(k)(i)(dd) will apply, resulting in the trust paying income tax on dividends that were previously exempt from income tax (Spamer, 2011:1). The new legislation on section 8EA and section 10(1)(k)(i)(dd) is currently open for comment from the public. It is imperative that future research be done on these sections as it will amend the way that tax has been treated in trusts

5.7 RECOMMENDATIONS

Depending on the legislative changes of section 10(1)(k)(i)(dd) and section 8EA it might not be a good idea for XYZ to continue with the AE Trust as the employees might be taxed on income that they would have received tax free in the past. XYZ should consider other ways of retaining and remunerating employees, such as cash bonuses or phantom share schemes. XYZ has to realise though that it will not be possible to reward the employees without the employee paying tax on the reward. XYZ would have to investigate ways of rewarding employees that will be beneficial for both the company and the employee whilst paying the minimum amount of tax on the reward.

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