

A CRITICAL ANALYSIS OF SECTION 8C: TAXATION OF DIRECTORS AND EMPLOYEES ON VESTING OF EQUITY INSTRUMENTS

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ABSTRACT

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With effect from 26 October 2004, section 8C was introduced into the Income Tax Act No 58 of 1962 and replaced the previous section 8A. The main purpose of the new section was to effectively tax directors and employees on the receipt of income from equity based incentive schemes and therefore close potential 'loopholes' that existed in the previous section 8A. The purpose of this study was to critically analyse section 8C and specifically the principles of 'vesting' and 'restricted equity instruments' as introduced by the section. Since no case law exists and the application of the principles within the section is deemed to be detailed and complex, the possibility for inconsistent treatment or misinterpretation exists. Due to limited information being available regarding the application of section 8C and in order to determine whether different interpretations may exist in practice, selected tax practitioners and/or specialists were also asked to provide information through the completion of a questionnaire. Section 8C has already been amended since its introduction and as indicated in the study, further amendments may be necessary in order to address problem areas. Employers with equity based incentives need to be aware of the significant impact that section 8C has on the taxation of equity instruments and have to ensure that they comply. Depending on the instruments in use it could also have a major impact on the administrative duties of employers, who have the responsibility of calculating and paying the necessary taxes on time.

OPSOMMING

‘N KRITIESE ONTLEDING VAN ARTIKEL 8C: BELASTING OP DIREKTEURE EN WERKNEMERS AS GEVOLG VAN DIE VESTIGING VAN EKWITEITSINSTRUMENTE

deur

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Artikel 8C is met effek vanaf 26 Oktober 2004 ingesluit in die Inkomstebelastingwet Nr. 58 van 1962 en het sodoende die vorige artikel 8A vervang. Die hoofdoel van die nuwe artikel was om direkteure en werknemers op ‘n effektiewe wyse te belas op inkomste uit ekwiteits-gebaseerde aansporing-skemas en dus potensiële ‘gapings’ wat in artikel 8A bestaan het te vul. Die doel van hierdie studie was om artikel 8C, en spesifiek die nuwe beginsels van ‘vestiging’ en ‘beperkte ekwiteitsinstrumente’, krities te analiseer. Aangesien geen hofsake bestaan nie en die voorgenoemde beginsels as ingewikkeld geag word, bestaan die moontlikheid van onkonsekwente hantering of misinterpretasie. As gevolg van die feit dat beperkte inligting beskikbaar is oor die toepassing van artikel 8C en om te bepaal of verskillende interpretasies wel bestaan in praktyk is enkele belastingpraktisyns en/of spesialiste gevra om inligting te verskaf in die vorm van ‘n vraelys wat voltooi is. Artikel 8C is reeds gewysig sedert 2004 en soos in die studie uitgewys, bestaan die moontlikheid dat verdere wysigings sal moet plaasvind ten einde probleem areas aan te spreek. Werkgewers wat gebruik maak van ekwiteits-gebaseerde aansporing skemas moet bewus wees van die wesenlike impak wat artikel 8C op die belasting van ekwiteitsinstrumente het en verseker dat hulle aan die wetgewing voldoen. Afhangend van die instrumente in gebruik kan dit ook ‘n groot impak op die administratiewe pligte van die werkgewers hê, wat die verantwoordelikheid het om die nodige belasting te bereken en betyds oor te betaal.

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CHAPTER 1 - INTRODUCTION

1.1 BACKGROUND

Due to the increasingly popular belief that companies should ‘pay for performance’, equity based compensation has increased dramatically in recent times. Mainly as a result of this increase in equity based compensation and the inability of section 8A to effectively tax the large variety of equity-based incentives for senior management, section 8C was introduced into the Income Tax Act No. 58 of 1962 (hereafter referred to as “the Act”) with effect from 26 October 2004.

Between 1992 and 2000 stock option compensation, as a percentage of total compensation for Chief Executive Officers in the Standard and Poor’s (“S&P”) 1,500 companies, increased from less than 25% to 44% (Gritsch & Snyder, 2007:343). While some research has been performed in the United States regarding share options and the taxation thereof, little attention has been given to analyse the impact and effectiveness of section 8C of the Act in the South African context and the potential tax issues that may exist should companies not understand the principles contained in the section, and adjust their share incentive schemes accordingly.

Up to 26 October 2004, section 8A of the Act determined that the main tax event would be the utilisation (exercise, cession or release) of any right to obtain marketable securities (such as share options). Due to the nature of certain schemes entered into by employers, the application and relevance of section 8A was uncertain. In contrast to section 8A, section 8C refers to vesting as the tax event. The date on which the equity instrument vests depends on whether the equity instrument is classified as restricted or unrestricted. Although the terms ‘vesting’, ‘restricted-’ and ‘unrestricted instruments’ are defined in section 8C, little research has been done to critically analyse the meaning and application of the terms in practice.

To date, the application of section 8C of the Act has not been tested in the courts and it is not clear whether South African (“SA”) companies have altered their equity based compensation plans (of which share option schemes are the most popular) to ensure

compliance with section 8C. According to Blair and De Beer (2006:1) both listed and non-listed companies have reviewed their share-based executive incentive schemes and if changes have not already been made, it is currently in progress or at least planned for the near future.

As mentioned by Griffing (2008:12), it is crucial for US companies to be aware of when options are exercised in order to ensure that the necessary taxes are paid over. In a South African context, the challenge of being aware increases, as the company may be required to pay over the necessary taxes on vesting of the shares and not necessarily on the exercise dates.

1.2 PROBLEM STATEMENT

No current case law exists to provide additional guidance to taxpayers with regards to the application of section 8C of the Act. In the absence of case law the taxpayer must rely on logic and an analysis of the definitions provided within the Act, which could lead to potential inconsistencies. The recent application for a private ruling from the South African Revenue Service (“SARS”) regarding the determination of the vesting date together with the withholding of the relevant taxes (South African Revenue Service, 2008:1) is indicative of the potential uncertainty that taxpayers may have.

The main purpose of this study is to critically analyse the main principles of section 8C and to determine whether a different interpretation may exist between the SARS and South African companies (taxpayers). Focus will be placed on share option schemes as these are the most popular form of equity-based compensation.

1.3 RESEARCH OBJECTIVES

The study will be guided by the following research objectives:

- To critically analyse the definitions of ‘vesting’ and ‘restricted equity instruments’ as provided in section 8C and to identify possible problem areas with the application of the terms in practice.

- To obtain information from tax practitioners regarding the interpretation and application of section 8C by taxpayers in practice, and to identify specific potential problem areas.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

In the year 2000, over 95% of Chief Executive Officers in the United States (S&P 1,500 companies) received some sort of stock option compensation (Gritsch & Snyder, 2007:350). Due to similar circumstances in South Africa, the legislator introduced section 8C to the Act in 2004 to ensure that senior management do not obtain an unfair tax advantage through the utilisation of the numerous equity-based incentive schemes developed (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004:10). In most cases, the tax advantage related to the fact that capital gains tax was payable on gains made, as these were not deemed to be normal earnings (Blair & De Beer, 2006:1).

This change in legislation impacts the date on which equity instruments are taxed and if not adhered to, could lead to penalties and interest charges. The tax event leading to the payment of taxes no longer refers to the exercising, cession or release thereof but to the vesting of the equity instruments.

Furthermore, little research has been performed on section 8C and no case law currently exists in order to provide guidance to the high number of taxpayers involved. All companies that issued equity based incentives after 26 October 2004 will be affected by section 8C. In addition, individual taxpayers in possession of equity based incentives should also be aware of the impact of section 8C as the tax consequences, and more specifically the timing thereof, could be severe.

According to Lomax (2008:15) initial research, as performed by Professor Erik Lie in the United States, indicates that 23% of stock option awards to top executives between 1996 and August 2002 were backdated or otherwise manipulated. The backdating of stock options has further raised concerns about the taxation of stock options and potential tax evasion.

The importance of the study lies within the complexity of the new legislation and the fact that little guidance exists with reference to the potential 'grey areas' within section 8C. The results of this study may be used by other researchers and students as a reference or point of departure for further research. Companies and other taxpayers may also be able to use this research to interpret the 'grey areas' within section 8C.

In the remainder of this chapter, the delimitations and definition of key terms are provided followed by the research design.

1.5 DELIMITATIONS

The study will:

- consider the basic system of taxation under section 8C by analysing the terms 'vesting' and 'restricted equity instruments' as defined in the section. The study will not include an analysis of section 8B;
- the study will not include all types of equity based compensation but will rather focus on share incentive schemes (share options), being a popular and commonly used equity based incentive scheme in South Africa. The study may not identify all areas where potential interpretation differences may exist; and
- the study will in essence be restricted to South Africa.

1.6 DEFINITION OF KEY TERMS

The definitions provided below are discussed in more detail in chapter 2.

Equity Instrument: Based on the definition provided in the Act an equity instrument relates to a share (or part thereof), an option to buy a share (or part thereof) or an instrument that can be converted into a share (or part thereof) of a company's equity share capital. The same principle would apply to a member's interest in a close corporation. It also includes "any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member's interest".

Vested: A right is vested in a person once he or she has all the rights of ownership, which rights are unconditional.

Restricted Equity Instrument: The complete definition of restricted equity instrument as per section 8C(7) of the Act is provided in chapter 3.2.2.1 below. In essence the definitions provides for specific circumstances under which an equity instrument will be regarded as a restricted equity instrument.

The following table indicates the abbreviations used in this document:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
SARS	South African Revenue Services
PAYE	Pay As You Earn
SAICA	South African Institute of Chartered Accountants
SA	South African
BPR	Binding Public Ruling
USA	United States of America
SAR	Share Appreciation Rights
S&P	Standard and Poor's

1.7 RESEARCH DESIGN AND METHODS - DESCRIPTION OF OVERALL RESEARCH DESIGN

As mentioned in the problem statement (chapter 1.2 above) the main purpose of this study is to critically analyse the main principles of section 8C. In order to facilitate the critical analysis the research design will primarily consist of a literature review.

Section 8C is a relatively new provision in the Act and therefore the literature available is very limited. In addition no case law is available in order to provide guidance regarding the application of the section and its rather complex terms and definitions.

However, due to the popular nature of equity based incentives some literature does exist that relate to this method of remuneration and in selected instances its tax implications.

Therefore, apart from the information provided in the Act and the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004, a search was conducted on the Internet, for any related information. Articles, opinions and commentary were identified that will form the basis of the review together with the other sources as mentioned above.

In addition, the amendments that have occurred since the introduction of the section, as well as any advance rulings that may have been requested, will be analysed in order to obtain the background and potential reasons for the amendments and rulings as this may provide valuable information regarding the interpretation of the provisions of the section.

Special attention will be given to the representativeness of the sources used as it is imperative in any literature review that the sources of the analysis are deemed to be representative.

The analysis will focus on the main terms and definitions provided in section 8C and will compare the contents of the section to the relevant guidance and commentary as gathered from the Internet search. The review of the literature is essential to ensure a proper understanding of the impact of section 8C in order to critically analyse the section and to identify any potential 'grey' areas that might exist. In addition, the analysis will be used to identify potential areas where different interpretations might exist between SARS and SA companies (taxpayers).

Information regarding differences in interpretation between SARS and taxpayers are usually contained in the relevant case law. Unfortunately no case law currently exists and due to differences between the tax treatment of equity based incentives in SA and foreign countries it is not deemed appropriate to study foreign case law in this regard. As a result, and in order to ensure that sufficient information is obtained to identify potential areas where different interpretations might exist with regards to section 8C of the Act, it was deemed appropriate to expand the literature review.

For this purpose a questionnaire will be compiled based on the results of the literature review and analysis of key terms within the section that will be sent to or used during interviews with selected experts (tax practitioners) working in the taxation environment.

The selection of individuals will include representatives from:

- Major auditing firms.
- Other auditing/tax consulting firms.

These individuals will be selected to ensure that widespread and impartial feedback is obtained from tax experts working with SA companies on a daily basis. The questionnaire will focus on potential grey areas as identified during the critical analysis of section 8C and will aim to provide additional insights regarding the proposed treatment and interpretation of tax experts in SA.

As the questionnaire will be based on the findings of the initial literature review and analysis of information, it is not possible to compile the questionnaire in advance. The individuals mentioned above will also be selected after the initial research to ensure that individuals with the necessary knowledge and experience as well as expertise are engaged.

It should be noted that the assumption is made that the view provided by tax experts in private practice will represent, to a large extent, the view of SA companies in general. The aforementioned represents a limitation in the study as questionnaires will not be sent to any SA companies. This decision is mainly based on the fact that not all companies have equity share incentive schemes and that, due to the confidential nature of matters relating to remuneration, representatives from companies may be reluctant to provide information in this regard. Impartiality and transparency could also prove to be a problem as the sensitivity of a company's tax affairs and potential non-compliance, may influence the completeness of any feedback provided.

CHAPTER 2 – GENERAL APPLICATION OF SECTION 8C

2.1 INTRODUCTION

Section 8C was introduced into the Act on 26 October 2004 and aims to effectively tax any gains made by employees and directors on equity instruments received from their employers by virtue of their employment. At first it would seem that such gains should be taxable under the definition of gross income and the provisions of the Seventh Schedule of the Act, which deals with benefits received as a result of being employed. However, paragraph 2(a) of the Seventh Schedule to the Act relating to the receipt of financial instruments by any employee/director specifically excludes instruments acquired under section 8A or 8C.

Being a fairly new addition and also regarded by many as a rather complex section, it is important to understand why the new section was introduced. It will also be helpful to gain a thorough understanding of the main terms used within the section and detail as to the general application of the section. This will be the main objective of this chapter.

The terms ‘vesting’, ‘equity instrument’ and ‘restricted equity instrument’ will be analysed and the definitions as per section 8C considered. In the subsequent chapters these terms and the application thereof in practice will be analysed in further detail in order to identify potential problem areas.

2.2 ANALYSIS

2.2.1 Reasons for the change

Section 8A was introduced into the Act in 1969 and attempted to include all gains that resulted from the exercise, cession or release of any right to acquire any marketable security, as income. The main objective of equity based incentives was always to retain worthy employees and to motivate them by ensuring that they also benefit from the growth and increased profitability of the company.

However, it was soon realised that if properly structured, the equity based incentives could have significant tax benefits. As a result companies all over the world developed complicated equity based incentive schemes that would go far beyond the straight forward share option schemes that originally existed.

According to the South African Institute of Chartered Accountants (“SAICA”) (2005:1) share incentive schemes, taxable under section 8A were developed with the main objective of maximising gains through limiting potential tax liabilities. Soon it was common practice to convert income of a revenue nature to that of a capital nature. Although capital gains tax was introduced on 1 October 2001, taxpayers only paid capitals gains tax at an effective rate of 10%, in comparison to the marginal tax rate of 40% applicable to revenue (SAICA, 2005:1).

This sentiment is echoed in the Explanatory Memorandum on the Revenue Laws Amendment Bill (2004:10) which states that section 8A did not manage to include all the growth in value of the underlying share or security as ordinary income since the section only included the amount of growth until the exercise, cession or release of that right. This growth amount could then be deferred until the restriction on the share was lifted or the share was sold, with the increase in value after conversion being taxed as a capital gain.

The Explanatory Memorandum on the Revenue laws Amendment Bill, 2004 (2004:10) further states that these schemes successfully altered the timing of the taxes to ensure payment of income tax when the underlying values were low and capital gains tax on the greater portion of the appreciation when the underlying values were high.

Section 8C was introduced in order to address the tax advantages that were available, mostly to affluent taxpayers, and thereby ensure that potential tax planning initiatives are eradicated (SAICA, 2005:1). As the majority of the schemes or incentives related to senior management and/or directors, it was clear that an unfair advantage existed whilst ‘ordinary’ employees paid normal tax on their total remuneration.

Even though the legislator could have considered amendments to section 8A, it is deemed that the complexity and array of schemes in the market called for a fresh approach with regards to the taxation of equity based incentive schemes. This included a

reconsideration of the tax event as well as the broadening of the ‘tax net’ to include all related instruments and not only ‘rights to acquire marketable securities’ as provided for in section 8A. The main differences between section 8C and section 8A are highlighted in the next section.

2.2.2 Comparison to section 8A

The table below provides a summary of the major differences between section 8A and section 8C. The objective of the table is mainly to point out the differences. Potential reasons and an analysis of the changes will be performed in the remainder of the study.

Table 2: Comparison between section 8A and section 8C

	Section 8A	Section 8C
Instruments included	Section 8A applied to any right to acquire any marketable security whereas marketable security included any security, stock, debenture, share, option or other interest that could be sold in a share-market or exchange or otherwise.	Section 8C applies to equity instruments which refers to a share (or a member’s interest) in a company, and includes an option to acquire such a share (or members interest), any financial instrument that can be converted to a share (or members interest), and any contractual right or obligation where the value of such right or obligation is calculated directly or indirectly with reference to a share (or members interest).
The tax event	The tax event referred to the exercise, cession or release of any right to acquire a marketable security. Therefore the taxpayer should include in his income any gain once the marketable security had been exercised, ceded or released.	The tax event refers to the vesting of any equity instrument. Therefore the taxpayer should include in his income any gain (or loss) once the equity instrument has vested in him.
Tax losses	Not applicable to any losses incurred.	Section 8C applies similarly to both gains and losses. Therefore a taxpayer must deduct from his income any loss, as

		calculated with reference to Section 8C, upon the vesting of any equity instrument.
Deferred payment of taxes	Section 8A allowed for taxes payable on any gains to be deferred where a restriction existed on the taxpayer whereby the taxpayer could not sell the marketable security until the restriction was lifted. The taxpayer had to elect to defer the taxes on the gain.	Section 8C also contains the deferral of taxes but it differs in the sense that the calculation of the gain is deferred until such time that all restrictions have been lifted. Therefore it is not merely a deferral of payment of taxes but rather a deferral of the determination of taxes payable.

Section 8C introduces and is primarily based on the principles of ‘vesting’, ‘equity instruments’ and ‘restricted equity instruments’. According to section 8A, the tax event was defined as the exercise, cession or release of a right whilst section 8C refers to ‘vesting’ as the tax event.

In contrast to section 8A, section 8C seeks to tax the full growth in the value of the equity instrument as ordinary income by postponing the taxation of such gain (growth) until all restrictions have been lifted and the full appreciation or growth has occurred. Under section 8A, companies structured their equity based incentive schemes in such a way that the appreciation or the majority thereof in the value of the equity instrument was not subject to tax or only subject to capital gains tax (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004:10).

An example of such a scheme would be the ‘deferred delivery scheme’ where the company agrees to transfer a number of shares to the employee after an agreed number of years. The current cost of the shares is only payable by the employee once the shares are transferred to him. After the agreed number of years the employee receives shares that are worth more but only pays the initial cost price. The gain would not be subject to normal income tax under section 8A as the initial cost of the shares is paid by the employee. However, after October 2001 the gain would have been subject to capital gains tax but the effective rate of 10% results in a 75% discount to the maximum marginal income tax rate of 40%.

A similar scheme existed whereby convertible debentures were used. The employee would purchase convertible debentures, either in cash or by means of a loan, from the company and after a number of years, the debentures would be converted to shares. At that time the loan to the company would be repaid but the appreciation in the value of the shares would not be subject to normal income tax under section 8A.

In both schemes mentioned above, section 8C would result in the full appreciation of the underlying shares being subject to normal income tax. This will become clear as the significant terms and general application of section 8C is analysed.

2.2.3 Definition of vesting

One of the most significant, if not the most significant, differences between section 8A and section 8C is the alteration of the tax event from ‘exercise, cession or release’ to ‘vest’. Even though the term ‘vesting’ is not specifically defined in section 8C, section 8C(3) states that, in the case of an unrestricted equity instrument, it is deemed to have vested in the taxpayer at the time of acquisition of the instrument. As noted by Simkins (2004:2), this agrees with previous guidance by the courts indicating that a right is deemed to be vested in a person as soon as the person owns it. This implies that the person has the full right of ownership including the right of enjoyment.

Simkins (2004:2) further notes that the word ‘vesting’ has been used in order to distinguish between what is certain and what is conditional: A vested right is therefore different from a right that depends on a future contingency or condition. This principle is also clear in section 8C(3) where it is stated that in cases of restricted equity instruments it will only vest in the taxpayer once all the restrictions cease to exist. Other actions that will result in vesting include disposal or deemed disposal of the restricted equity instrument, termination of the restricted equity instrument (in selected instances) and death of the taxpayer.

The principle of ‘vesting’ is also used in tax legislation relating to trusts in order to describe the rights that the beneficiaries may have and to distinguish a vested right from a contingent right. In ITC 76 (1927:70) it was held that “vesting implied the transfer of dominium” and “A vested right was something substantial, which could be measured in money”.

Legal-Explanations.com (not dated) also refers to vesting as an “unconditional transferral” of a right and that the person in which the right vests obtain the benefits associated with the right. Merriam Webster Online (not dated) adds that it is a “legally fixed immediate right of present or future enjoyment”. In summary, a right is vested in a person once he or she has all the rights of ownership, which rights are unconditional.

It is clear from the above that the term ‘vesting’ goes hand in hand with the definition of restricted equity instruments as vesting is deemed to be unconditional and therefore all restrictions must cease to exist for vesting to occur. Given the complexity of the myriad of equity based incentive schemes available, this poses the first major challenge in determining the date of vesting.

In the binding public ruling: BPR021 (“BPR 021”) the South African Revenue Service (2008:5) states that, amongst other requirements, the options granted in the specific scheme that were the subject of the private ruling, will not vest until the option has been exercised. Even though this ruling provided some insight into the definition of vesting it also raised doubt as to whether a clear distinction exists between the date of vesting and the date of exercise. The mere fact that a binding public ruling was requested is also indicative of the potential uncertainty that exists regarding the principle of vesting.

In addition, as soon as vesting occurs, it is the responsibility of the employer to deduct the necessary income tax (PAYE) should a gain exist. However, based on the current wording of the section, it may be possible that vesting can occur without the employee actually exercising the right to obtain the underlying share in cases of a share option agreement. The application of the term ‘vesting’ and the potential anomalies or grey areas that could exist will be analysed in Chapter 3.

2.2.4 Definition of equity instrument

It is important to note the definitions as provided in section 8C of the Act as no further guidance has been provided in any case law to date. Based on the initial definition provided in the Act in 2004, an equity instrument relates to a share (or part thereof), an option to buy a share (or part thereof) or any financial instrument that can be converted

into a share (or part thereof) of a company's equity share capital. The same principle would apply to a member's interest in a close corporation.

'Financial instrument', as defined in section 1 of the Act, includes "a contractual right or obligation, the value of which is determined directly or indirectly with reference to a debt security or equity; any commodity quoted on an exchange; or a rate index or specified index".

It is clear from the above that the definition of equity instrument is very wide. However, soon after the introduction of section 8C, new equity based incentives emerged that circumvented the provisions of the section (Surtees, 2008:6). Once again the payment of normal income tax on the full appreciation of the underlying equity instruments was avoided.

This resulted in an amendment to section 8C, expanding the definition of equity instrument to include "any contractual right or obligation the value of which is determined directly or indirectly with reference to the underlying share" (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008:23).

As a result of the inclusion, the employee or director with a mere contractual right to the value or appreciation in value of the shares and no such right in the shares itself, will also be taxed under section 8C (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008:23).

2.2.5 Definition of restricted equity instrument

Together with the definition of vesting and equity instrument, the definition of 'restricted equity instrument' forms the basis of section 8C. According to Kruger (2006:1), a restricted equity instrument is subject to restrictions such as a prohibition of the disposal thereof freely at market value and that it may not be deliverable until the happening of a certain event other than payment of the purchase price.

Refer to chapter 3.2.2.1 below for the complete definition of a restricted equity instrument provided in section 8C of the Act. Similar to the definition of equity instrument above, the

definition of restricted equity instrument had to be expanded after new equity incentive schemes successfully circumvented section 8C.

The new schemes provided for other financial penalties on the employees for non-compliance to employer restrictions on the shares i.e. no restrictions on the employer shares themselves (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008:22). As a result, the equity instruments did not qualify as restricted equity instruments and gains could be taxed at an earlier stage as no restrictions existed.

The definition of restricted equity instrument is very important because once the equity instrument qualifies as a restricted equity instrument the potential gains will only be taxed once the restrictions have all ceased to exist. Companies will seek to structure equity incentives in such a way that it is not deemed to be restricted in order to optimise the tax benefit.

However, another potential problem exists in cases where the nature and extent of the restriction is not clear. This will be analysed in detail in chapter 3.

2.2.6 General application of section 8C

In summary, the date of inclusion of the gain or loss for tax purposes is dependent on whether the equity instrument is restricted or unrestricted. In the case of unrestricted equity instruments, this date will be the date that the equity instrument is acquired.

Based on the definitions above, the tax event for restricted equity instruments will only occur once all restrictions have been lifted and the equity instrument vests in the employee. Simkins (2004:1) seems to agree with this statement and points out that section 8C, in comparison to section 8A, will result in the taxpayer being taxed as soon as all restrictions on the taxpayer to sell the specific instrument cease to exist.

Subsections 2(a) and 2(b) of section 8C contain the provisions regarding the determination of the gain or loss. However, the taxpayer will in general, at the vesting date, include in his normal income the difference between the market value and the consideration applicable to that equity instrument. In this regard, Simkins (2004:1) notes that should an equity

instrument vest during a specific year of assessment, any profit or loss should be included in the taxpayer's income for that year of assessment.

The profit or loss should be calculated in accordance with section 8C and will apply if the taxpayer received the equity instrument as a result of his employment with any company. The following example indicates the general application of section 8C for an uncomplicated equity based incentive scheme:

Scenario 1:

Employee A receives a grant of 100 options allowing him to exercise his options and acquire 100 shares in the company after 3 years, at a cost of R10 per share. The market value of a share is R50 in year 3. The employee only exercises his options in year 6 when the market value of a share is R100.

The share options are deemed to be an equity instrument under section 8C as it represents an option to buy a share in the company. In addition, the employee is only allowed to exercise his options in year 3, indicating that it is a restricted equity instrument under the definition of restricted equity instrument in section 8C(7).

Vesting can therefore only occur once all restrictions have ceased to have an effect as per subsection 3(b) of section 8C. From the facts provided in scenario 1, the restriction ceases to have an effect in year 3 and as a result employee A will have to include R4000 $((R50 - R10) \times 100)$ in his income in year 3. Only in year 6 will employee A actually exercise his options and therefore be taxed on R5000 $((R100 - R50) \times 100)$ as a capital gain. Several questions arise from this example:

- Should the employer pay over Pay-As-You-Earn ("PAYE") in Y3 even though the options were not exercised and no realised gains were received by employee A?
- Did the option/equity instrument really vest in year 3, or only once it was exercised in year 6?
- What if the value of the option depreciated up until year 3?
- What if it depreciated after year 3 and the normal tax was already paid?

Questions such as the aforementioned will be analysed in the following chapters.

2.3 CONCLUSION

It can be safely concluded that section 8A was not effective in subjecting the majority of gains relating to equity based incentives to normal income tax. Based on the number and complexity of the equity based incentive schemes available, it is also clear that SARS had to introduce a new approach which explains the significant differences between section 8A and section 8C.

Section 8C introduced a new tax event into the Act namely 'vesting' as well as new terms such as 'restricted equity instruments'. Even though the meaning of vesting is reasonably clear from the definitions provided above and section 8C provides a detailed description of when an equity instrument is deemed to be restricted, the interpretation and application thereof in practice may not be so straight forward.

Even in the uncomplicated scenario above, certain questions or potential areas for debate are evident and once again certain 'loopholes' surfaced when the section was originally applied by companies. As a result, both the definitions of 'equity instrument' and 'restricted equity instrument' have been amended and SARS also issued an advance tax ruling regarding the determination of the date of vesting.

SAICA (2005:2) states that section 8C in its current format has resulted in interpretation differences but that SARS is reconsidering the section or parts thereof. Kantor and Taylor (2007:1) mention 'changes in tax legislation' as one of the three main reasons why companies are experiencing difficulty in effectively managing and administering their current share incentive schemes. Potential problem areas or areas where interpretational differences may exist, specifically with regards to the tax event, will be analysed in Chapter 3.

CHAPTER 3 – THE TAX EVENT

3.1 INTRODUCTION

In this chapter a detailed analysis of the ‘tax event’ in section 8C, namely vesting, will be performed. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (2004:10), the delayed tax event (vesting date) for restricted equity instruments represents the core of the new section 8C.

It is important to understand the tax principles supporting the tax event and how they compare to the basic principles found in paragraph (i) of the definition of gross income in the Act, together with the provisions of the Seventh Schedule of the Act under which the majority of employee benefits are taxed. An analysis of other references to the term ‘vesting’ in the Act should also assist in obtaining an understanding of the tax event and the potential for interpretative differences.

Due to the change in the date of the tax event from section 8A to section 8C, companies will have to determine the impact on their equity based incentive agreements as well as their payroll administration. However, the manner in which companies interpret the new term will determine the level and nature of the impact and change required.

Arguably the main objective with the change in the tax event from section 8A to section 8C was to ensure that companies can no longer utilise equity based incentives in order to convert ordinary income into income of a capital nature. However, in doing so the possibility also exists that other interpretative issues may arise as the concept of vesting is new.

This chapter aims to analyse the concepts of ‘vesting’ and ‘restricted equity instruments’ which form the basis of the tax event in section 8C. In addition an analysis of the deduction of losses under section 8C will be performed.

3.2 ANALYSIS

3.2.1 Vesting as the tax event

The date of vesting depends on whether the equity instrument is restricted or unrestricted. In the case of unrestricted equity instruments, vesting will occur upon the date of acquisition which according to Simkins (2004:2) agrees to the meaning that the courts have given to the term vesting.

The tax event in section 8A referred to the exercise, cession or release of a right which action would normally be performed by the taxpayer. The taxpayer would therefore be conscious of the action and should be aware of the tax implications of that action.

Herein lies one of the challenges with regards to vesting. Vesting may not be dependent upon any action from the taxpayer but rather of the complex terms and conditions of a typical equity based incentive scheme. In order to obtain an understanding of the concept of vesting, it is necessary to analyse similar or related principles in the Act.

3.2.1.1 **Comparison to other employee benefits received**

Section 8C(a)(i) specifically states that a gain or loss from an equity instrument will only be included in a taxpayers income should the taxpayer have received it as a direct result of his or her employment or directorship of any company. The majority of employee benefits are taxed under paragraph (i) of the definition of gross income in the Act which paragraph includes the cash equivalent, calculated in accordance with the provisions of the Seventh Schedule, of the value “of any benefit or advantage granted in respect of employment”.

Due to the inability to effectively tax the complex equity based incentives under paragraph (i) and the Seventh Schedule to the Act, section 8A was introduced and later on replaced with section 8C, once again due to the inability to levy tax effectively. Even though paragraph (i) specifically excludes amounts to be included under the new sections, the objective and principal to value, and tax the benefit received by the employee or director as normal income should in principle be the same.

Paragraph 2(a) of the Seventh Schedule states that a taxable benefit shall be deemed to exist once an asset has been acquired by the employee for no consideration or a consideration which is deemed to be less than the value of the asset. It is important to note that the tax event is therefore the acquisition of the asset. Even though section 8C refers to the tax event as vesting par 3(b)(i) states that in the case of an unrestricted equity instrument, vesting will occur once the taxpayer acquired the instrument. This indicates that the tax event and broad principle is similar as long as the equity instrument is an unrestricted equity instrument.

In the case of restricted equity instruments, it is more complex as the income tax is determined at the time of vesting which is not necessarily the time of acquisition or disposal (Kantor and Taylor, 2007:1).

Section 8C(7) of the Act states, *inter alia*, that “a restricted equity instrument vests at the earliest of—

- i) when all the restrictions, which result in that equity instrument being a restricted equity instrument, cease to have effect;
- ii) immediately before that taxpayer disposes of that restricted equity instrument, other than a disposal contemplated in subsection (4) or (5)(a), (b) or (c) ;
- iii) immediately after that equity instrument, which is an option contemplated in paragraph (a) of the definition of ‘equity instrument’ or a financial instrument contemplated in paragraph (b) of that definition, terminates (otherwise than by the exercise or conversion of that equity instrument);
- iv) immediately before that taxpayer dies, if all the restrictions relating to that equity instrument are or may be lifted on or after death; and
- v) the time a disposal contemplated in subsection (2)(a)(i) or (b)(i) occurs”.

Paragraph (ii) to (v) of section 8C(7) is deemed to be straight forward and apart from a potential problem with paragraph (iii) as indicated in chapter 3.2.1.5 below interpretation would not seem to be a problem. Paragraph (i) is deemed to be the most important and will probably lead to the vesting of the majority of restricted equity instruments. As soon as all restrictions are lifted, the equity instrument vests in the taxpayer and this enables the legislator to include the majority of the appreciation in the equity instrument in the

taxpayer's normal income (Spamer, 2008:1). However, according to Kantor and Taylor (2007:1) taxation problems may exist where the exercising of a right (option et cetera) occurs after the vesting of the right.

The receipt of a restricted equity instrument is probably comparable to the receipt of an asset for no consideration or a consideration that is less than the market value of the asset at the date of receipt, as per paragraph (i) and the Seventh Schedule. However, should options be received entitling the taxpayer to purchase shares in the company at an agreed value, it could be regarded as a 'right' to purchase shares. In real terms no benefit will be received until the right has been exercised and the shares have been purchased.

When referring to a 'right' paragraph 2(a) and (b) of the Seventh Schedule of the Act states that the employee will only be taxed for the period during which such employee had the use of the asset. It could be argued that this implies that the employee shall only be taxed once the right of use is exercised. There is however a distinct correlation between the date of the tax event and the actual receipt of the benefit.

Based on the above, the question can be raised whether it should be possible for an equity instrument to vest if the 'right' (e.g. share option) has not been exercised? Or, will vesting always result in the taxpayer being taxed only once the benefit is received i.e. the use of the underlying asset has been obtained?

In the previous section 8A, the tax event related to the 'exercise, cession or release' of a marketable security. It is clear that the taxpayer had to 'action' the tax event and thereby received the benefit of an asset at potentially no or less consideration than the market value of that asset. This seems to be in line with the provisions of the Seventh Schedule.

According to Butler (2005:21) the vesting does not necessarily indicate the exercising or disposal of the option or share but merely that the taxpayer must be in a position to exercise or dispose thereof. Vesting can therefore occur without any 'action' from the taxpayer. Consider the scenario provided under chapter 2.2.6 above where the taxpayer only exercised his options in year 6 but the options already vested in year 3 as all restrictions ceased to have effect.

It could be argued that the true nature of the transaction or the taxpayer's intention was only to receive the benefits in year 6 upon exercising the options. If compared to the right of use of an asset, it would seem reasonable to argue that the taxpayer should only be taxed once he exercises the options, i.e. obtains the use of the asset, and thereby actually receives the benefit.

It is however more complex as the nature of the 'right' (e.g. share option) has to be analysed in order to determine whether the share option in itself can be regarded as an asset or whether it is purely a right to acquire an asset. In practice, the majority of share options issued are deemed not to be freely disposable at market value.

Based on the definition contained in section 8C(7), an equity instrument will be deemed to be restricted if it can not be freely disposed of by the taxpayer at market value. In this case, it would seem that the options referred to in scenario 1 may only vest in year 6 should the taxpayer not be able to freely dispose of his options after year 3. This would then seem to be in line with the taxation of other employee benefits as the taxpayer is only taxed once the options ('right' to acquire) has been exercised and the benefit has been received by the employee.

In contrast, should the taxpayer be able to freely trade with the options at market value, he will be liable for the tax in year 3 without having received any actual income. However, the taxpayer did receive an asset, at a value lower than market value (should the value of the underlying shares have appreciated) and will be taxed in line with the provisions of the Seventh Schedule and par (i) of the definition of gross income.

Therefore in both instances, the underlying principle seems to be in line with that of paragraph (i) of the definition of gross income and the Seventh Schedule of the Act.

3.2.1.2 Share appreciation rights ("SAR")

According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (2004:10) section 8C will endeavour to tax restricted equity instruments in a similar fashion as SAR. It further states that according to SAR cash is received at predetermined dates as

the underlying share value of the company appreciates, and that the cash or benefit so received is taxed on those dates (in the years of assessment).

The similarity can be seen in the fact that section 8C will also attempt to include the full appreciation of the underlying share value in normal income and not income of a capital nature as was previously possible under section 8A. The difference being that SAR are taxed at predetermined intervals as the benefit, whether it is cash or shares to the value of the appreciation of the underlying share, are actually received by the taxpayer.

This difference may be significant especially when the underlying share price depreciates. In the case of SAR, the deemed result would be that the employee or director would receive no cash or shares and therefore there will be no tax consequences. However, under section 8C the depreciation in the underlying share value of the equity instrument will under normal circumstances result in a loss deductible for tax purposes.

In addition, SAR are usually dependent upon the participants remaining employed by the company together with reaching agreed performance objectives (Kantor and Taylor, 2007:2). Even though these might seem like restrictions, it is not really of any relevance as the employee will only be taxed once he or she receives the cash, shares or other benefit to the value of the appreciation in the underlying share value. The Explanatory Memorandum on the Revenue Laws Amendment Bill (2004:10) also states that normal tax is applicable for the taxpayer as the benefit (cash etc.) is received.

For restricted equity instruments in section 8C, vesting only occurs once all restrictions cease to exist. Butler (2005:21) indicates that should the instrument itself or an amount relating to the restricted equity instrument, be received by the taxpayer before that instrument has vested in the taxpayer, it would be disregarded for income tax purposes.

Reference should also be made to the potential problem that exists within the application of subsection 3(b)(iii) of section 8C of the Act as considered under point 3.2.1.5 below. SAR do not seem to have a similar problem as the value of the benefit received is taxed with no reference to the termination of such rights.

Based on the above, it is deemed that even though the taxation of SAR can be compared to the taxation of restricted equity instruments, in accordance with section 8C, some differences also exist which should be considered.

In addition, due to new equity based incentive schemes developed after the introduction of section 8C, the definition of equity instrument as stated in section 8C(7) was expanded during 2008. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (2008:23) the new definition of equity instrument will include “any contractual right or obligation the value of which is determined directly or indirectly with reference to the underlying share”.

It would seem that this expansion of the definition of equity instrument will result in SAR to fall within the ambit of section 8C as it refers to a contractual right and its value is certainly determined with reference to the value of the underlying equity of the company. The question is whether this will impact on the way that SAR were taxed previously as the tax event will now be based on the vesting of the equity instrument and not on the acquisition of receipt of the benefit e.g. cash, shares etc.

The tax consequences will be dependent on the specific terms and conditions of each scheme but in general SAR would be deemed restricted equity instruments as it is usually dependent upon the performance of the employee as well as remaining employed by the specific company. In addition, the employer will have to be very aware of any other potential restrictions that may exist and could result in the rights not vesting upon payment of the appreciation value as it is still deemed to be restricted equity instruments under the definition in section 8C(7).

As an example, the employer may retain the right to cancel or reverse the potential benefit to be received by the employee based on bad performance or weak company results (refer paragraph (b) and (c) of the definition of restricted equity instrument), or the employer has agreed to repurchase the rights from the employee at a price exceeding the market value of the right should the value of the underlying share decline (refer paragraph (f) of the definition of restricted equity instrument). The latter example may be relevant to SAR as a decline in the underlying share value may result in the employee receiving no benefit.

Kantor and Taylor (2007:2) states that the amount due in accordance to a share appreciation right scheme is paid through the buying of shares in the specific company and thereby aligning the objectives of the shareholders and employees or directors. As a result another scenario that could exist is if the rights received in accordance with a share appreciation right scheme is freely disposable at market value but the benefit to be received e.g. the shares as per Kantor and Taylor (2007:2), is in the form of a restricted equity instrument (for example can not be freely traded with).

As far as options (paragraph (a) of the definition of equity instrument) and financial instruments (paragraph (b) of the definition of equity instrument) are concerned, this situation is catered for by paragraph (d) and (e) of the definition of restricted equity instrument in section 8C(7). The options and financial instruments shall be deemed to be restricted equity instruments if the equity instruments that can be acquired through the exercise or conversion are restricted equity instruments. This would be the case even though the options or financial instruments may have no restrictions i.e. are freely disposable at market value.

Therefore the aforementioned scenario as applicable to equity instruments resulting from the new paragraph (c) of the definition of an equity instrument is not yet specifically included in the definition of a restricted equity instrument. Even though SAR are usually not freely disposable at market value SAR are only one of many potential schemes that will be addressed by the new paragraph (c).

If the complexity of the share schemes together with the inherent complexity of section 8C is considered, the possibility exists that employers are not fully aware of the impact of section 8C together with the recent changes to the section. As indicated above, the recent changes to section 8C may alter the taxation of SAR. As will be discussed in chapter 4, employers will have to revisit their equity based incentive schemes and the detailed terms and conditions thereof to ensure that they are aware of the changes and comply with the requirements of section 8C.

3.2.1.3 Relation between vesting and ‘accrued to’

A similarity seems to exist between the terms ‘vesting’ and ‘accrued to’ as contained in the Act. In ITC 76 (1927:70) it was held that “In the income tax sense, therefore, a vested right was an accrued right.” Both terms can be regarded as tax events as income tax will be charged as soon as vesting takes place or as soon as income accrued to a taxpayer (as per the definition of gross income in the Act). What makes the comparison significant is that in both cases the taxpayer may not have received the actual benefit or income but that the value of the benefit will be included in his or her normal income.

In contrast with the term ‘vesting’ a lot has been said about the term ‘accrued to’ in the courts and in some instances the term ‘vesting’ was used to indicate that accrual has taken place. In CIR v Polonsky (1942:16) it was held that even though income had not been paid to a beneficiary but rather invested on her behalf, the income had vested in her, and therefore had accrued to her.

In *Lategan v CIR* (1926:57) it was held that the term ‘accrued to’ means to be ‘entitled to’. This meaning was also held in *CIR v People's Stores (Walvisbaai)* (1990:9). Being entitled to income seems very similar to the principle of vesting, which according to Simkins (2004:2), relates to when a person owns a right or have “all rights of ownership in such right including the right of enjoyment”.

It could also be argued that the vesting of income is a prerequisite for accrual of income. Therefore, if a restriction exists resulting in income not vesting in a taxpayer, it would probably also not accrue to the taxpayer. The contrary would also then be true in that once income has vested in a person it has accrued to him which would support the principle of vesting as a tax event.

The principle of ‘accrued to’ and the numerous commentaries and case law in this regard is deemed useful in interpreting the meaning of a ‘vested right’ or the ‘vesting’ of a right. The relationship between ‘accrued to’ and the vesting of a right as it relates to section 25B of the Act is further analysed below.

3.2.1.4 Vesting in section 25B

Section 25B(1) states that “Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.”

Section 25B of the Act regulates the income of trusts and beneficiaries of trusts. No definition is provided for ‘vested right’ in the section but the term is used to describe the rights that beneficiaries have in accordance with what is known as the ‘conduit principle’. According to this principle, the right that a beneficiary has could be of such a nature that even though income is received by the trust or trustees of the trust, it actually accrues to the beneficiary and will therefore be taxed in the hands of the beneficiary. Spamer (2008:3) states that when a trust received income to which a beneficiary has a vested right, such income will be deemed to have accrued directly to the beneficiary. In other words, the trust or trustees merely act as a conduit in this regard.

It would seem that such a right has to be unconditional and the beneficiary must be entitled to the income i.e. the income is for the benefit of the beneficiary. Therefore the use of the word vest is notable in this instance implying that vesting is regarded as being final and provides the beneficiary with an unconditional right which will be taxable regardless of whether the income is actually received. This seems to be in accordance with the purpose of the term vesting in section 8C.

In accordance with section 25B, if no vested right exists to the income, the beneficiary will only be taxed on the amount he actually received with the remaining portion to be taxed in the hands of the trust or trustee. In contrast to section 8C, no guidance is provided as to when a vested right exists, mainly because vesting is not used to describe the tax event in section 25B, but rather to indicate that the right to the benefit is unconditional and that the beneficiary is fully entitled to the income.

3.2.1.5 Vesting upon termination of equity instruments

According to subsection 3(b)(iii), a restricted equity instrument (limited to an option as per par (a) or a financial instrument as per par (b) of the definition of equity instrument in section 8C(7)) will vest immediately after it terminates.

This subsection may prove to be problematic as the taxpayer may be in a situation where he or she is taxed on a benefit that was not actually received. The following scenario has reference:

Scenario 2:

Director B receives a grant of 100 options allowing him to exercise his options and acquire 100 shares in the company after 3 years at a cost of R10 per share. The market value of the shares is R10 per share in year 3. According to the share option agreement the options will terminate after a period of 4 years if not exercised by the director. The director decides not to exercise the options in year 4 as, (a) he did not have the cash available to pay the exercise price of R10 even though the market value is R12 per share; or (b) the market value of the shares is R5 per share in year 4 resulting in a loss of R5 per share. Assume that the options are not freely disposable after year 3 and therefore are deemed to remain restricted after year 3.

With reference to (a) above, in accordance with subsection 3(b)(iii), the director will have to include R200 ($100 \times (R12 - R10)$) in his ordinary income in year 4 even though he did not exercise the options and received no benefit. The reason being that the options terminated in year 4 resulting in the options to vest in the director as per subsection 3(b)(iii) above.

With reference to (b) above, as the value of the shares depreciated and therefore the exercise price of R10 is in excess of the share value of R5, it is not considered feasible to exercise the options in year 4. However, in accordance with par 3(b)(iii) no action is required from the director as the termination of the options will result in the options to vest and therefore a loss of R5 will be included in the normal income of the director in year 4.

Kruger (2006:1) states that tax will be payable should an option be disposed of but that it is unlikely in the case of lapsing of an option as no income would be received as a result of the lapsing. Kruger adds that if the employee was required to pay for the option, it would result in a loss.

According to SAICA (2005:3), the wording of subsection 3(b)(iii) is deemed to be problematic. This is clear from the scenarios presented above as it does not seem fair that in (a) above the director should be taxed on a benefit that was, and will never be received. Similarly in (b) above the loss that will be included in the income of the director does not seem fair as no expense was incurred by the director and no value is deemed to have been lost.

The above calculations were based on subsection 2(a)(ii) and 2(b)(ii). It should be noted that subsection 2(a)(i)(bb) and 2(b)(i)(bb) are applicable to gains and losses incurred when a taxpayer disposes of an option or financial instrument by means of release, abandonment or lapsing. It states that the gain or loss in such cases will be limited to the amount by which the consideration paid for the share option or financial instrument exceeds the amount received or accrued upon disposal. If the intention was to include terminations of share options and financial instruments under this subsection, it is deemed that the word 'terminations' would have been included in the wording of the subsection as it is explicitly used in the wording of subsection 3(b)(iii).

Should the intention have been that subsection 2(a)(i)(bb) and 2(b)(i)(bb) be applicable to terminations, it is not clear how the profit or loss would have been determined. No amount would have been received as per subsection 2(a)(i) or 2(b)(i). The subsection does not refer to the market value in order to determine the value received or receivable but rather to "...the amount received or accrued in respect of that disposal". It is argued that the amount received or accrued would be zero indicating that no gain or loss exists which would probably be a fair reflection.

However, the definition of 'consideration' as per Section 8C(7) states, inter alia, that it includes "...any amount given or to be given...". Therefore it could be argued that in the case of a loss ((b) above), even though no amount is actually given when the option terminates, an amount 'to be given' does exist, in this case the R10 exercise price. Since

both subsection 2(b)(i) and 2(b)(ii) refer to the term 'consideration' it could be deemed that the loss would exist in both cases.

Uncertainty may exist as to which paragraph is applicable especially since the determination of the vesting date as per subsection 3(b)(iii) specifically refers to terminations and subsection 2(a)(ii) and 2(b)(ii) seems more appropriate as it refers to the difference between the consideration regarding an equity instrument and the market value of that equity instrument on the vesting date.

3.2.2 'Lifting' of the restrictions

The concept of a restricted equity instrument was introduced by section 8C (Simkins, 2004:2). Therefore, similar to vesting being the tax event, restricted equity instrument is also a new concept in the Act. Even though the tax event or trigger relates to vesting, vesting of restricted equity instruments can only occur once all restrictions cease to have effect.

According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (2004:12), the majority of equity incentive schemes include restrictions forced down by the employers. The memorandum also points out that the definition of restricted equity instruments in section 8C was very broad to ensure that it covers the numerous equity based incentive schemes that existed at that time.

However, since the introduction of section 8C in 2004, companies have developed new schemes in order to bypass the provisions of section 8C (Surtees, 2008:6). This included schemes where the restrictions did not relate to the employer shares but rather to other financial penalties on the employees, thereby falling outside the definition of restricted equity instruments as per section 8C (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008:22). This resulted in the proposed expansion of the definition in 2008 as per the Explanatory Memorandum on the Revenue Laws Amendment Bill 2008.

This section will focus on the concept of restrictions in general, selected paragraphs within the definition of restricted equity instruments and the application thereof in practice.

3.2.2.1 Legislation

Before analysing certain elements of the definition it is important to provide the new, expanded definition as it is stated in section 8C of the Act:

According to section 8C a “restricted equity instrument’ in relation to a taxpayer means an equity instrument—

- a) which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;
- b) which is subject to any restriction that could result in the taxpayer-
 - i) forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or
 - ii) being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;
- c) if any person has retained the right to impose a restriction contemplated in paragraph (a) or (b) on the disposal of that equity instrument;
- d) which is an option contemplated in paragraph (a) of the definition of ‘equity instrument’ and where the equity instrument which can be acquired in terms of that option will be a restricted equity instrument;
- e) which is a financial instrument contemplated in paragraph (b) of the definition of ‘equity instrument’ and where the equity instrument to which that financial instrument can be converted will be a restricted equity instrument;
- f) if the employer, associated institution in relation to the employer or other person by arrangement with the employer has at the time of acquisition by the taxpayer of the equity instrument undertaken to—
 - i) cancel the transaction under which that taxpayer acquired the equity instrument; or
 - ii) repurchase that equity instrument from that taxpayer at a price exceeding its market value on the date of repurchase, if there is a decline in the value of the equity instrument after that acquisition; or

- (g) which is not deliverable to the taxpayer until the happening of an event, whether fixed or contingent;”

3.2.2.2 Legitimacy of restrictions

In scenario 1, as per chapter 2.2.6 above, the employee was granted 100 share options that could be exercised after 3 years implying that he or she should remain in the employment of the company for this period. It was argued in chapter 3.2.1.1 that the timing of the tax under section 8C would depend on whether any other restrictions existed after 3 years. If no restrictions exist, the share options would vest in the employee and he or she will be taxed in year 3.

In order to test whether any other restrictions exist, the scheme or agreement with the employee should be tested against each paragraph contained in the definition above. Given the complexity of some of the equity based incentive schemes, this might not be a straight forward exercise and even SARS had to expand the definition in 2008 as companies succeeded in circumventing the definition. Below are selected arguments with regards to the application of the definition of ‘restricted equity instrument’ in practice.

Paragraph (a) – Freely disposable

The majority of restrictions imposed in an equity based incentive scheme should be clear from the terms and conditions of the share scheme. In addition, the majority of restrictions will probably be instituted by the employer or his representative. Paragraph (a) of the definition of a restricted equity instrument states that the taxpayer should be in a position to freely dispose of the equity instrument at market value.

Therefore, in the aforementioned scenario (scenario 1) one of the main questions, as discussed in 3.2.1.1 above, would be whether the share options are freely disposable at market value. If so, the employee will be taxed under section 8C in year 3 provided that no other restrictions exist.

However, it could be argued that the employee is in fact in a position to freely dispose of the share options as the 3 years have passed and in accordance with the agreement the

employee is free to exercise the options. As a result, it could be said that the only real restricting factor is that the employee, on his own account, decided not to exercise. This would seem like a self-imposed restriction rather than an 'external' or employer-imposed restriction.

It is deemed that the employee now has the full right to exercise the share option and obtain the benefit. It seems that the inability to freely dispose of the share option is in fact not an actual restriction as it could be bypassed by merely exercising the option, thereby adding to the argument that it is a self imposed restriction. In other words, is it possible for a restriction to exist with regards to a taxpayer if the power to nullify the restriction lies with the taxpayer?

This argument touches on the subject of chapter 3.2.1.1 above as it is deemed that the employee is, in year 3, 'entitled to' the benefits (potential gains) of the asset (underlying shares) and therefore it has accrued to him, as would be the case under paragraph (i) of the definition of gross income in the Act. The mere fact that the employee decides not to utilise the opportunity (exercise the right) may be insignificant.

It could be compared to an employee receiving a gift card (voucher) from the employer. The gift card, made out to the employee, will not be freely disposable at market value as it can only be redeemed at a specific shop by the specific employee. It is probable that the employee will be taxed upon receipt of the voucher and not once the voucher has been redeemed or used for the purchase of goods. Similarly, the decision to redeem the voucher lies with the employee.

In contrast to paragraph (f), paragraph (a) of the definition of restricted equity instrument refers to any restriction and does not limit it to restrictions imposed by the employer or related party. Therefore it is deemed that, as it currently stands in the Act, the share options in scenario 1 will not be taxed in year 3, should it not be freely disposable at market value, even though the restriction could be regarded as a self-imposed restriction under the control of the taxpayer. The 'validity' of the restriction is however questionable.

Paragraph (b) - Forfeiting ownership

In accordance with paragraph (b), the equity instrument will be deemed to be restricted should the possibility exist that the taxpayer will forfeit ownership (“or the right to acquire ownership”) as a result of the restriction. Several equity based incentives such as share option schemes contain a termination date whereby the employee has a limited period in which to exercise the share options after which the options will be terminated.

Termination would usually indicate that the right to acquire ownership, e.g. of the share through the share option, has been forfeited and thereby the opportunity is lost for the employee. The restriction needs to be read together with paragraph 3(b)(iii) which indicates that the share option will vest immediately after it terminates. The potential problem with the application of this paragraph was discussed in chapter 3.2.1.5 above.

In addition, the following scenario should be considered:

Scenario 3

Director X receives a grant of 1000 options allowing him to exercise his options and acquire 1000 shares in the company after 3 years at a cost of R10 per share. The share options are freely disposable but according to the agreement the director will forfeit his right to acquire the shares (options) should he resign from the company and has not exercised the options. However, upon resignation the director has 3 months after the date of resignation to exercise his options.

In the above scenario the director will not be taxed in year 3 because there is a restriction in place that could result in the taxpayer forfeiting ownership. The question that arises is whether the abovementioned restriction is in fact a restriction? Even though the director stands to forfeit his right to exercise the share options, he will be given another 3 months after resignation in order to exercise his right. Is there a point at which a restriction is of such a nature that it will not be deemed a ‘valid’ restriction in terms of section 8C?

Considering that one of the main purposes of section 8C is to tax the majority of the appreciation in the value of the equity instrument or underlying share, it is deemed that the slightest of restrictions would be regarded a ‘valid’ restriction resulting in the instrument to be, or remain a restricted equity instrument.

This argument will also be held in the next example as it relates to the happening of an event as per paragraph (g) of the definition of a restricted equity instrument. With regards to the ‘validity’ of restrictions also refer to the section below regarding paragraph (c).

Paragraph (g) - ‘The happening of an event’

Paragraph (g) of the definition of a restricted equity instrument includes equity instruments that will not transfer to the taxpayer “...until the happening of an event, whether fixed or contingent”. Even though the concept of restricted equity instruments is new to the Act, the concept of a fixed or contingent event is also seen in section 7(5) of the Act.

Section 7(5) of the Act provides for the allocation of income in cases where a ‘donation, settlement or other disposition’ has been made by a person and the beneficiaries will only receive the related income upon the happening of a fixed or contingent event. In essence there is a great similarity between the sections as the income will only be allocated or taxed in the hands of the beneficiaries once the event has taken place. This principle is similar to that of section 8C where in the case of paragraph (g) of the definition of a restricted equity instrument the instrument will remain restricted, and therefore not vest, until the happening of the event, whether fixed or contingent.

The benefit in this regard is that the question of what constitutes an ‘event’ has been thoroughly discussed in literature pieces, including case law, as it relates to section 7(5). One aspect of determining whether an event exists was subject to debate and that was whether, in the case of a trust, the exercise of discretionary powers by the trustees represented an ‘event’. This discretion could for example include the right to withhold or distribute income to beneficiaries.

After several legal cases had commented on this topic, it is deemed that an event would include the discretionary powers of the trustees and therefore the beneficiaries will only be taxed once the trustees have distributed the income to them or in effect the event has occurred.

Therefore, in the case of paragraph (g) in section 8C, there should not be a problem in determining whether an event exists and should the employer have discretionary powers in deciding over a restriction or allocation of equity instruments, this should also be

regarded as an event. In such cases, it is deemed that the restricted equity instrument shall not vest until the event has occurred, or in this example the employer (or whatever party) has used its discretionary powers.

Paragraph (c) – Retention of the right to impose a restriction

According to paragraph (c), an equity instrument will be restricted as long as any person still has the right to enforce a restriction, similar to the restrictions mentioned in paragraph (a) and (b) of the definition, on the disposal of the equity instrument. Paragraph (a) refers to the inability to freely dispose of the equity instrument at market value and paragraph (b) refers to restrictions that could result in the taxpayer forfeiting his rights.

The ‘validity’ of restrictions were shortly discussed above under paragraph (b) – forfeiting ownership. Similar circumstances may be applicable with reference to paragraph (c). Most publicly listed companies have so called ‘closed periods’ during which directors and employees are not allowed to trade or exercise any shares or share options held in the company.

It could be argued that this represents a restriction to freely dispose of the equity instruments at market value. Paragraph (a) specifically exclude restrictions imposed by legislation and therefore it could be argued that this limitation provide for the legislation regarding insider trading (Sec 440F of the Companies Act of 1973 (No 61 of 1973) and the Insider Trading Act of 1998). However the legislation regarding insider trading is aimed at persons who trade in any form of equity whilst having insider knowledge.

The closed periods referred to above is not a restriction imposed directly by legislation even though it might be as a result of legislation. Employees and/or directors who do not have insider knowledge may also be affected by a closed period even though they would have complied with the relevant legislation if they traded in the company’s equity. Therefore, this limitation could be seen as retention of the right to impose a restriction to freely trade in the equity of the company.

In accordance with subsection 1(a)(ii) this could have the effect that if a restricted equity instrument for example share options are exercised and the shares are obtained, vesting will not occur because the shares obtained will also be regarded as restricted equity

instruments. The shares will be regarded as restricted equity instruments because paragraph (c) of the definition of restricted equity instruments will be applicable as indicated above.

In effect this could result in the exercising of share options without the vesting thereof in the hands of the taxpayer. If so, companies need to be aware as no tax will be applicable in such circumstances until immediately before the shares are disposed of as per section 8C(7).

3.2.2.3 Binding Public Ruling: BPR 021

SARS (2009) states on its website that the objective of Advance Tax Rulings is to support amongst other things certainty on the interpretation and application of selected tax legislation by the Commissioner. Therefore it could be argued that taxpayers usually apply for advance rulings in cases where uncertainty exists regarding the application of selected tax laws.

Binding Private Ruling: BPR 021 (“BPR 021”) was issued on 14 July 2008 and the issues considered in the ruling related to the determination of the vesting date of a restricted equity instrument and the determination of the date on which employees’ tax should be withheld on any gains that arose on such date. This section will focus more on the first of the two issues.

In BPR 021 SARS (2008:1) points out that the vesting event is based on facts and will be determined by the provisions of the relevant equity based incentive scheme (in that case the Trust deed). In addition the definition of restricted equity instrument and the provisions of subsection (3)(b) of section 8C should be considered. In the case of BPR 021, it would seem that uncertainty existed regarding the date of vesting. Several restrictions were imposed by the relevant Trust Deed but it may not have been clear which of the restrictions would be regarded as ‘valid’ restrictions and would therefore have to cease to exist before vesting can occur.

According to the information supplied, the Trust Deed included two obvious restrictions namely that options were subject to exercise dates (one third after two years et cetera)

and the options would lapse after the seventh anniversary or if the holder was sequestrated. It is possible that the applicant in this regard could have argued that the options may vest once the above mentioned restrictions cease to exist.

Based on the argument raised under chapter 3.2.2.2 (Paragraph (a) – Freely disposable) above, the possibility exists that the fact that the options could not be traded freely may not have been deemed a restriction after the abovementioned exercise dates have lapsed as the option holder was free to exercise the option. This may have resulted in uncertainty as to the date of vesting.

The fact that SARS (2008:6), in the ‘specific ruling’ in BPR 021 specifically states that the options “have not vested despite the minimum periods stipulated in clause 16 of the Trust Deed having expired” may be an indication that the exercise dates was considered to be the main, if not the only restriction, and that vesting would take place once the periods have lapsed.

Based on the above it is deemed that even though certain restrictions, like the ones mentioned above, are specifically imposed in order to restrict the relevant option holders, other restrictions may exist that are not as clear from the wording of the Trust deed or whose inclusion may not necessarily have been intended as a restriction. As an example the Trust Deed in BPR 021 indicated that the option price must be paid in full once it is exercised.

Even though it might seem obvious that the option price should be paid once an option is exercised, it is deemed to be a specific restriction in BPR 021 and therefore vesting can not occur prior to the payment of the full option price. This opens up a new argument as to whether vesting can occur prior to the exercising of an equity instrument, especially if any consideration is payable upon exercising of the right.

In the case of share options, an option price is payable in most instances and therefore it could be argued that vesting would only occur once the payment is made, in other words when the option is exercised. The specific ruling in this case indicates that the options granted would remain restricted equity instruments until the exercise dates have been reached (minimum periods passed), the options have been exercised and the option price

have been paid. As long as the options remain restricted equity instruments vesting can not occur.

The fact that the options have to be exercised in order to vest may be an indication that SARS is of the opinion that an option that is exercisable, even though that option may not be freely tradable, can not vest until the option holder actually decides to exercise the option. In this case vesting seems to be similar to the previous section 8A where the tax event referred to the 'exercise, cession or release' of any right to acquire any marketable security.

However, Kantor and Taylor (2007:1) points out that when the exercise of a right occurs after the 'vesting date', such schemes will create tax problems. Based on the provisions of BPR 021 it may not seem likely that vesting will occur prior to exercise but what is clear is that the exercise date remains an important factor when vesting is determined.

In addition, it is clear from BPR 021 that each equity based incentive scheme will be treated on the merit of its specific provisions and that section 8C and specifically the scope of the definition of a restricted equity instrument is very wide and should be carefully considered by companies. Selected terms and conditions of equity based incentive schemes may be deemed to be restrictions even though it was not the intention of the employer and this will have a significant impact on the date of vesting.

3.2.3 Losses incurred

In contrast to section 8A, section 8C allows for a loss that arises on vesting to be deducted from income for tax purposes (SAICA, 2005:4). The loss to be deducted can be determined with reference to subsection 2(b) of section 8C which provisions are very similar to subsection 2(a) and the determination of gains to be included.

The first potential problem with regards to losses was discussed under chapter 3.2.1.5 above and related to the vesting of restricted equity instruments upon termination. The definition of the term 'consideration' was also considered in this section. Other potential problem areas will be discussed below:

Decreases after vesting

Kantor and Taylor (2007:2) points out that a potential problem with current schemes may exist where employees/directors are in a position where a decrease in the share price occur between the date of vesting and the date of disposal. Consider the following scenario:

Scenario 4:

Employee A receives a grant of 100 options allowing him to exercise his options and acquire 100 shares in the company after 3 years at a cost of R10 per share. The market value of the share is R50 in year 3. The employee only exercises and disposes of the shares in year 6 when the market value of a share is R15 per share.

Under the assumption that the options were freely disposable at market value and therefore vested in year 3 the above scenario would place the employee in a negative position. Employee A will have to include in his normal income in year 3, R4000 $((50 - 10) \times 100)$ and will probably be liable for tax at the marginal rate of 40%. The tax will be payable even though the options were not exercised and no shares were actually disposed of i.e. no income was actually received by the employee. As previously indicated this treatment could seem unfair but since an asset is deemed to have been received at less than its market value it is probably a fair result.

However, upon exercising the options and disposing of the shares in year 6 the employee will incur a loss of R3500 $((50-15) \times 100)$. This loss will be of a capital nature and therefore the tax advantage of the deduction will only be at an effective rate of 10% (marginal rate of 40% x the inclusion rate of 25% for individuals with capital gains). The net effect from a cash flow perspective would be that the employee lost R750 (profit on disposal in year 6 of R500 less tax burden in year 3 of R1600 plus tax advantage in year 6 of R350) even though share options at a cost of R10 were exercised and sold at a price of R15.

To a large extent the loss in the above scenario is the result of the actions of the employee but it should also be kept in mind that companies endeavour to align the objectives of shareholders and employees/directors and therefore promote and support the retention of equity by employees. This will be further analysed in chapter 4.

A potential solution would be to provide for a delay in tax similar to the provisions of section 8A(1)(b) as soon as the exercise date and the vesting date differs. Alternatively the tax loss should be granted at a similar rate than the rate used to tax the gain upon vesting.

Utilisation of future losses

As far as equity based incentives are concerned timing is very important. Firstly the timing of the tax event is mainly what led to the introduction of section 8C as the previous section 8A did not succeed in taxing the majority or complete appreciation in the equity value as normal income.

Secondly, as indicated above, the timing of the tax event and the subsequent disposal of the shares could result in dire consequences for the taxpayer if the shares decrease in value between the date of vesting and the date of disposal.

Another timing issue that has emerged is the backdating of share options. Backdating involves the granting of options at a historic date when the share value was very low in order to increase the gain in the hands of the option holder. In South Africa it would have been very beneficial to back date options to a date prior to 26 October 2004 in order to ensure that it remains taxable under section 8A.

In the United States, the Securities & Exchange Commission, Department of Justice and Inland Revenue Services have joined forces in investigating cases where options may have been backdated (Alexander, Hirschey & Scholz, 2007:25). Lomax (2008:15) compares the potential scandal of backdated options to Enron and Worldcom and points out that over 200 corporations are currently under investigation for potential backdating.

Backdating would probably be indicative of fraudulent activities and should lead to a criminal investigation. But what if timing could be utilised to the tax benefit of employees in what would seem to be a legal way? Consider the following scenario:

Scenario 5:

Company A's share value is currently R100 per share. The company is aware of a material event in the near future that would probably result in the share value to decline significantly. The company grants its directors 100 000 options each, which options only

become freely tradable at market value after 1 year. After 1 year the share price has declined to R5. No other restrictions are placed on the equity instruments.

In accordance with the definition of a restricted equity instrument in section 8C(7), the share options will be classified as restricted equity instruments as it cannot be freely traded with at market value in year 1. As soon as the restriction ceases to exist (after one year) the options are deemed to vest in the directors.

In accordance with the provisions of subsection 2(b)(ii) the loss will be calculated by deducting the consideration relevant to the equity instrument from the market value of the equity instrument at the vesting date. According to the definition of 'consideration' in section 8C(7) it includes "...any amount given or to be given..." by the taxpayer regarding that equity instrument. In the scenario above the amount given or to be given on the date of vesting is deemed to be the exercise price of the option which is R100. The market value is deemed to be R5 as that is the value of the underlying share once the consideration is paid.

Therefore a loss of R9,5 million (100 000 x R95) would be deducted from the income of the taxpayer after one year. At the marginal income tax rate of 40% it would mean a net deduction of R3,8 million for the director. Should the value of the shares increase to R200 after 10 years and the director decides to sell the options the gain of R10 million (100 000 x R100) would be taxed as a capital gain at a maximum rate of 10% (40% income tax rate at a capital gains inclusion rate of 25%). This would result in a net inclusion of R1 million and a clear financial advantage to the director. Even if the share value never reaches R100 the director would have received the benefit of the tax deduction.

Should SARS argue that a restriction does exist for example the payment of the exercise price must be made (similar to BPR 021), it could result in a scenario where a director could sell his options and not be taxed on the proceeds thereof as a restriction still exists and therefore the equity instrument cannot vest. This may not be problematic should the share price have decreased but certainly when the share price appreciated.

Global crises like the one experienced in 2008 and 2009 might create the opportunity for companies to develop equity based incentives whereby employees and or directors could benefit from a tax perspective as share prices are almost sure to decrease.

3.3 CONCLUSION

The responsibility to close the 'loopholes' and stop the endless attempts to circumvent tax legislation compels SARS to continuously monitor and amend the provisions of the Act. In certain instances, the level and nature of the circumvention causes the Legislator to review the applicable section and, if necessary, change it altogether. This seems to be the case with section 8C. From the number of equity based incentives that existed and successfully circumvented the previous section 8A, it was clear that a new approach was necessary.

It is however clear that the new approach resulted in the introduction of new concepts in 'vesting' as the tax event together with 'restricted equity instruments'. Another significant difference from the previous section 8A is the fact that losses can now be deducted for income tax purposes. In essence it is deemed that the new tax event is based on sound principles and is in accordance with the basic principles relating to the taxation of gross income and specifically employee benefits as contained elsewhere in the Act.

As could be expected, the introduction of new concepts will result in potential interpretative differences or problem areas that need to be resolved and if applicable amendments should be made. In the case of section 8C such amendments have occurred and BPR 021 indicated that uncertainty may still exist in the application of the section in practice.

Being a fairly new section and given the complexity of the equity based incentive schemes that it must deal with, it is probable that future amendments and or enhancements will occur. As stated by Butler (2005:23) it may take time to completely 'reveal' all the possible scenarios that are deemed to be covered by section 8C.

The question whether vesting can only occur at exercising remains unanswered. Based on BPR 021 it seems unlikely that a difference will exist in practice but from a theoretical point of view it could be argued differently. It is however not a critical question if the end result is

in line with the objective of section 8C to include the appreciation of the equity instruments in normal income.

It is deemed that the major risk from a tax perspective may not be whether section 8C successfully addresses the vast number of schemes that is available, but rather whether companies with 'previous' equity based incentive schemes and companies developing new schemes are aware of the implications of section 8C and whether they have made the necessary adjustments in order to cater for the tax consequences.

This will be the focus of chapter 4.

CHAPTER 4 – THE IMPACT OF SECTION 8C ON COMPANIES

4.1 INTRODUCTION

Based on the analysis performed in chapters 2 and 3 above, the recent amendments to section 8C as well as the recent application and issuance of a Binding Public Ruling (BPR 021), it is fair to say that interpretative differences may exist with regards to the provisions of section 8C and more specifically the application thereof in practice.

Kantor and Taylor (2007:1) mention changes in tax legislation as one of the three main reasons why companies are experiencing difficulty in effectively managing and administering their current share incentive schemes and also points out that new initiatives are taking place throughout the world with regards to equity based incentive schemes.

From the majority of commentaries relating to section 8C on the Internet, it is clear that concern exists as to the appropriateness of share based incentives that existed under section 8A and the significance of the potential tax impact should companies not review their share based incentives together with the impact that section 8C has on the taxation of those incentives. The tax event has changed and therefore, depending on the company's interpretation of section 8C, the timing of the payment of employee's tax may differ from that under section 8A.

SAICA (2005:5) advises employers to review their equity based incentive schemes based on the new income tax rules and further cautions employers that ignorance of the new rules could result in unforeseen tax implications, especially for their employees/directors.

Blair and De Beer (2006:1) state that most SA listed companies that have completed reviews of their equity based incentive schemes have introduced new equity based incentive schemes. They also note that tax changes, specifically with regards to section 8C of the Act are one of the main drivers of change to equity based incentive schemes.

According to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 (2004:15) any gains made as a result of the vesting of an equity instrument fall within the ambit of 'remuneration' as defined in the Fourth Schedule of the Act and will therefore be

subject to employee's tax. As companies are responsible to deduct and pay employees' tax to the revenue authorities, the concern has to be raised whether companies have ensured that a system is implemented whereby they will be able to identify all instances where equity instruments vest, in order to calculate, deduct and pay over the necessary employees' tax (PAYE).

This chapter will focus on the impact that section 8C may have on companies and the potential problem areas that may exist.

4.2 PAYMENT OF EMPLOYEES' TAX

Section 8C is only applicable if equity instruments were received "by virtue of" the taxpayer's employment or directorship of a company. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (2004:13) a gain or loss resulting from the vesting of an equity instrument will be treated similar to an adjustment to salary.

4.2.1 Employer's responsibility for employees' tax

Any gain that exists on the date of vesting falls within the definition of remuneration in the Fourth Schedule of the Act and as a result will be subject to employees' tax (Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004:15). It is therefore clear that employers have the responsibility to deduct employees' tax once a gain has realised on the vesting of an equity instrument.

As indicated by SARS (2008:1) in BPR 021, apart from the determination of the vesting date, the main issue was the determination of the date on which the employer should withhold employees' tax. The principle established in BPR 021 is that the date of vesting results in the liability of the employer to withhold employees' tax.

It is deemed that the determination of the vesting date can be rather intricate especially if the equity based incentive scheme contains multiple provisions, restrictions et cetera and is therefore complex. Under section 8A, the determination of the tax event usually relied upon an 'action' taken by the employee/director when he or she exercised, ceded or

released the financial instrument. Vesting as per section 8C on the other hand may not require any action from the employee/director and in certain cases the taxpayer may not even be aware that the equity instrument has vested. In addition, it is also possible that an equity instrument vested as a result of an action taken by the employee/director (e.g. which resulted in the 'lifting' of all restrictions to cease to exist) but that this was not communicated to the employer.

Paragraph 11A(2) of the Fourth Schedule states, *inter alia*, that employees' tax should be deducted once the equity instrument has, "to the knowledge" of the employer vested in the employee/director. It could be argued that the phrase 'to the knowledge' of the employer is vague or indefinite when it comes to allocating the responsibility of withholding employees' tax as there seems to be several instances where the employer may not be aware (or 'carry knowledge') that vesting has occurred and therefore may not withhold employees' tax.

As argued in chapter 3.2.2.3 above, the applicant may not have regarded the exercise and/or payment of the exercise price as 'restrictions' and therefore could have determined the vesting date, as well as the date of withholding employees' tax, incorrectly. Should no ruling have been applied for in this case, it could be argued that the applicant would only have deducted employees tax when, to the knowledge of the employer, the equity instruments vested, which could have been an incorrect date.

Based on the above, it could be argued that the employer may, in these instances, still be in compliance with paragraph 11A(2) as, to his knowledge, the equity instrument had not vested. However, it is deemed that the employer will find it difficult to prove that he acted in good faith and did everything reasonably possible to be aware of the vesting dates.

According to Butler (2005:21) the withholding of employees' tax based on paragraph 11A(2) of the Fourth Schedule may be a 'contentious' issue once future legal cases need to be decided. However, the responsibility of withholding employees' tax remains that of the employer and in accordance with BPR 021 takes effect on the date of vesting. This underlines the importance of determining and identifying the date of vesting and the significance if the provisions of section 8C are not interpreted correctly.

4.2.2 Administrative burden on companies

As indicated in the section above, the withholding of employees' tax is the responsibility of the employer. Therefore employers need to implement a system whereby the vesting dates of equity instruments can be tracked to ensure that employees' tax are withheld and paid over to SARS. Several risks may exist for companies in this regard:

4.2.2.1 Previous section 8A

Under the previous section 8A, employees' tax was withheld once the employee/director exercised, ceded or released the financial instrument. It is deemed that the process of tracking the tax event may have been less complicated as the exercise of a financial instrument usually means some form of communication with the company which would serve as a reminder that employees' tax should be withheld.

This may not be the case under section 8C as the date of vesting may not require any 'action' from the employee/director especially if it is argued that vesting can occur without the exercising of an equity instrument (refer arguments in chapter 3). In addition, several equity instruments which may not have been subject to section 8A and the definition of financial instrument will now be subject to section 8C and the definition of equity instrument which is deemed to be much 'wider', especially after the recent expansion of the definition.

As a result, companies may not be aware that they have instruments that now fall within the ambit of section 8C and should therefore be taxed under the section. Furthermore, companies may decide to maintain their method of taxing equity instruments as uncertainty exists as to the application of section 8C.

4.2.2.2 'Lifting' of restrictions

Even though one rule or condition within an agreement can apply to one equity instrument or holder of an equity instrument, it may not be applicable or relevant in all instances. It is also possible that restrictions which are applicable to all equity instruments may cease to exist at different time intervals. Consider the following scenario:

Scenario 6:

Employee A and B receive shares in company X, which shares can only be traded freely once A and B's respective departments reach R1m profit. Employee A's department reaches the target of R1m profit in July 2007 and employee B's department only reaches that target in January 2008.

In accordance with section 8C, vesting will only occur once all restrictions cease to exist. Therefore vesting will occur in July 2007 with regards to employee A and in January 2008 with regards to employee B.

According to Blair and De Beer (2006:2) one of the major trends in the market is that more companies are adding performance hurdles in their equity based incentives. Therefore it is deemed that scenarios like the above will increase over time. The problem is that the company will have to implement a system whereby it will be able to track when each employee (in this case employee A and B) reaches his or her target as the equity instrument (in this scenario) will vest on that day, even though no action is necessarily taken by the employees on that day.

4.2.2.3 Date of vesting

In addition to tracking the 'lifting' of all restrictions for all individuals the requirements for determining the date of vesting will place an additional burden on the company. According to subsection 3(b) of section 8C vesting of restricted equity instruments will also occur immediately prior to disposal, immediately after it terminates (only selected equity instruments), immediately before the taxpayer dies and at the time of disposal in accordance with subsection (2)(a)(i) or (b)(i).

Therefore companies will have to track all of the abovementioned dates in order to ensure that employees' tax will be withheld once any of the provisions occur. Most equity instruments have termination dates and in addition termination can also occur for several reasons. Therefore the tracking of all these dates will put an additional administrative burden on companies.

4.2.2.4 General

The question could be asked whether the onus of identifying and recording the vesting dates are solely that of the employer. Paragraph 11A(6) of the Fourth Schedule states, inter alia, that an employee should inform his employer once he has disposed of “any qualifying equity share as contemplated in subparagraph (1)”. Subparagraph (1) includes gains resulting from the vesting of equity instruments. However, paragraph 11A(6) refers to the disposal of an instrument which can not be compared to the vesting of an instrument and therefore the reference to subparagraph (1) may not be clear.

In addition, the term ‘qualifying equity share’ used in paragraph 11A(6) agrees only to the term used in paragraph 11A(1)(b) which specifically relate to section 8B. In other words, the terms ‘a right to acquire a marketable security’ (paragraph 11A(1)(a) and section 8A) and ‘equity instrument’ (paragraph 11A(1)(c) and section 8C) was ignored in paragraph (6), further indicating that paragraph (6) may not relate to the vesting of equity instruments.

As a result it could be argued that even though paragraph (6) places some responsibility on the employee to inform his employer it does not relate to vesting or the ‘lifting’ of restrictions which result in vesting. Therefore, in the case of scenario 6 above the employee may not be under any obligation to inform the employer once he reached the target of R1m profit as he did not dispose of any equity instruments. This would increase the problem of the employer being aware of such information in order to withhold the necessary employees’ tax.

Even though some differences exist between the tax provisions relating to equity based incentives in South Africa and the United States of America (“USA”) a similar problem exists in the USA with regards to payroll administration. Griffing (2008:12) points out that it is crucial for the payroll manager to be informed once options are exercised as there are significant penalties should the necessary taxes not be deducted.

This view is shared by Anon (2007:5) who points out that the one major problem in stock (equity) transactions, which is a common concern for payroll departments, is receiving notification of equity transactions. Unfortunately, as mentioned above, it may be possible

for vesting to occur without a physical 'equity transaction' which makes it even more difficult.

It would seem that the introduction of section 8C will require companies to consider the impact on their current equity based incentive schemes, as well as during the implementation of future equity based incentive schemes. What is certain is that section 8C will place an additional administrative burden on companies which, if not properly managed, could lead to severe penalties and interest.

4.2.3 Treatment of losses

In contrast to section 8A, losses incurred on the vesting of equity instruments can be deducted from normal income under section 8C. However, no reference is made to the treatment or deductibility of section 8C losses in part 2 of the Fourth Schedule.

It could be argued that the employer is under no obligation to include section 8C losses in the calculation of employees' tax but this could seem unfair as gains have to be included on the day, or within the month that the gain realised. If this is the case the taxpayer will only be able to deduct the section 8C losses once he completes his annual tax return or provisional tax returns.

Section 8C only states that "the taxpayer" must include any profit or loss in the relevant "year of assessment". Therefore no reference is made to the employers' responsibility in this regard.

4.3 THE POTENTIAL IMPACT ON EQUITY BASED INCENTIVE SCHEMES

Equity based incentive schemes may have several objectives but amongst the most important is the retention of key employees/directors and motivation of these employees/directors through alignment with the interests of shareholders. This motivation is mainly created through the potential financial advantage of growth in the underlying equity value.

One common thread runs through most of the commentaries regarding the introduction of section 8C and that is that it will have a definite impact on companies with current as well as future equity based incentive schemes.

Kruger (2006:2) states that the new section 8C will compel companies to consider the tax consequences prior to implementing a share scheme. SAICA (2005:1) points out that section 8C may have a negative impact on both the employee and employer if no changes are made from the pre-October 2004 regime. In addition, SAICA indicates that the restructuring of existing equity based incentive schemes can be extremely difficult and that professional advice would be recommended in this regard (SAICA, 2005:2).

Kantor and Taylor (2007:1) name changes in taxation as one of the main reasons why current share incentive schemes may not be feasible or effective anymore from an employer and employee perspective.

According to Spamer (2008:1) section 8C may have resulted in share incentive trusts losing its popularity, and in conventional share option schemes to once more, be the incentive scheme of choice for tax practitioners. Butler (2005:21) indicated that employers need to consider “a lot of underlying aspects’ with regards to the new provisions of section 8C.

Some aspects of the potential impact on the company have already been discussed in chapter 4.2 above. Aspects relating specifically to the potential impact on equity based incentive schemes are discussed below.

4.3.1 Equity retention of employees and directors

As mentioned above one of the main objectives of equity based incentive schemes is aligning the interests of employees/directors and shareholders. This alignment is obtained when employees/directors own shares (equity) in the company and therefore also benefit once the value of the shares increase. This could provide the necessary motivation for the employees/directors to increase profitability in an effort to increase the share value.

However, it could be argued that the provisions of section 8C will result in less equity retention by employees/directors as a direct result of the timing of the tax event. In contrast to section 8A tax will be charged on the full, or majority of the appreciation in the share value resulting in a significant amount of tax payable at the taxpayers' marginal rate on the date of vesting.

Any profits, calculated as the difference between the market value and the consideration paid on the vesting date, will not be taxed at the time of disposal but on the date of vesting. Therefore employees/directors could find themselves in a position where they have to exercise their rights on the vesting date in order to pay the tax liability and if relevant, the option price (Kantor & Taylor, 2007:1).

As indicated in previous chapters it gets worse if vesting occurs prior to the exercise of an equity instrument because the taxpayer will have to pay employees' tax at his marginal rate but has not exercised or disposed of any equity instruments. As a result it is likely that the taxpayer will also have to sell his shares (or other equity instruments) in order to pay the necessary taxes.

Blair and De Beer (2006:4) seem to agree with this statement and also points out that under the current equity based incentive schemes, equity retention will decrease significantly at the vesting date as employees/directors have to pay employees' tax. It is also stated that the average equity retention at the date of vesting is only 15% in South Africa (Blair & De Beer, 2006:4).

A further argument that relate to the above is that employees/directors may be forced to make unfeasible or uneconomical financial decisions. This is possible as they may be aware of significant growth in the company but are not able to retain their shares because of the tax implications of section 8C.

Even though it could be argued that section 8C resulted in the inability of selected equity based incentive schemes to promote equity retention, or even force taxpayers to sell at unfeasible or inappropriate times, the objective of tax laws should not be confused with that of companies or taxpayers. Under section 8A it is deemed that selected taxpayers, usually members of management (including the directors), received an unfair tax

advantage as income was received but not taxed, or only taxed as capital gains whilst other employees were taxed on their full salaries.

Therefore it is argued that section 8C cannot cater for the objectives of equity based incentive schemes whilst undermining the basic principles of tax and vertical equity. Companies will however need to devise a new strategy in order to promote equity retention. Refer to chapter 4.3.3 below in this regard.

4.3.2 Share dilution

When companies issue equity instruments it usually goes hand in hand with a dilution in their share value and earnings per share. These are important values for any company and therefore should be an important factor to consider when issuing shares within an equity based incentive scheme.

It could be argued that section 8C will result in an increase in share dilution. If a company decides to persist with their previous equity based incentive scheme and this scheme made use of the potential tax benefits under section 8A, employees/directors will have a reduced benefit with regards to equity instruments (e.g. share options) received after 26 October 2004.

The above could result in a scenario where the company has to issue more share options to ensure that the value in the hands of the employees/directors remain the same, even after a higher percentage of employees' tax has been deducted under section 8C. Kantor and Taylor (2007:2) call the additional shares to be issued in such case "inefficient" and agrees that it could affect the earnings per share. Blair and De Beer (2006:3) also include share dilution as one of the main criteria for evaluating equity based incentive schemes.

Similar to the discussion in chapter 4.3.1 above section 8C may have a negative impact on share dilution but once again it can not be the responsibility of the legislator to consider such factors above the basic principles of taxation.

The tax consequences of section 8C together with factors such as share dilution and the retention of equity by employees/directors, have led to the development of several new equity based incentive schemes. This will be the focus point of the section below.

4.3.3 New equity based incentives

Soon after the introduction of section 8C the process of developing new equity based incentive schemes, which will circumvent the provisions of section 8C, commenced. Surtees (2008:6) notes that numerous schemes with this objective have already been set up. It could be argued that in order to bypass the provisions of section 8C, the specific instrument should not fall under the definition of an 'equity instrument'.

Another possible method would be to ensure that the vesting date occurs earlier so that a limited amount of the appreciation of the underlying share is taxed (similar to previous schemes under section 8A). This only seems possible if the instrument does not qualify as a restricted equity instrument as contemplated in section 8C and therefore vesting will not be delayed until all restrictions cease to exist (and all or most appreciation is included in normal income).

It could be argued that apart from the aforementioned other attempts to maximise tax efficiency would have to rely on and utilise the provisions of section 8C if possible. Refer to chapter 3.2.3 above where it was argued that the deduction of losses may benefit taxpayers. The challenge for employers is that it remains important to align the interests of the employees with that of the shareholders and this is difficult to do if the underlying instrument is not directly linked to the equity of the company. Therefore instruments are likely to be linked to the share values of the companies which brings section 8C into play.

Surtees (2008:6) mentions two types of schemes that were developed since the introduction of section 8C in 2004. The first scheme makes use of an instrument which does not qualify as an equity instrument but whose value is determined with reference to the equity of the specific company whilst the other scheme resulted in financial penalties outside the scheme if the employee did not comply with the provisions of the scheme (Surtees, 2008:6).

The above schemes circumvented the tax consequences of section 8C because either the instrument did not qualify as an 'equity instrument' or the restrictions placed on the instrument did not result in the instrument being a 'restricted equity instrument' as per section 8C. In order to address these, and other similar schemes, the definitions of 'equity instrument' and 'restricted equity instrument' was expanded in 2008. In both cases it would seem that the legislator was successful in addressing the aforementioned schemes.

It is probable that companies will in future still seek to develop new schemes that will once again circumvent the current provisions of section 8C. However, with the inclusion of the new paragraph (c) to the definition of 'equity instrument' in section 8C, it will be very difficult to link the instruments to the company's equity without qualifying as an equity instrument. Therefore it is argued that further schemes may rather attempt to bypass the definition of a restricted equity instrument but it would seem to be a difficult challenge with the wording as it currently stands.

It is also possible that companies will move away from equity based incentive schemes and attempt to link performance bonuses et cetera to the growth of the company to ensure that employees' and directors' interests are still aligned with that of the shareholders. It could be argued that performance bonuses, already taxed at the marginal rate are much easier to administrate, hold other benefits like being fully tax deductible, and still have value even if the share value of a company depreciate. Even though performance bonuses may even be subject to the new paragraph (c) it should not have a material effect on the employees' tax payable.

According to Blair and De Beer (2006:1) most South African companies that have reviewed their equity based incentive schemes (after the introduction of section 8C) have introduced new equity based incentive schemes. However, it is noted that the changes could raise new concerns which include, a reduced ability to retain employees, less retention of equity (i.e. poor alignment with shareholder interests) and a decrease in the grant values (either by reducing the number of participants or the value per employee) as a result of higher taxes (Blair & De Beer, 2006:2).

Blair and De Beer (2006:2) as well as Kantor and Taylor (2007:2) point out that there has been a move towards Hare Appreciation Rights ("SAR") schemes. Under these schemes

participants obtain the right to an amount, at specific intervals, which amount is determined by the growth in the company's equity value (Kantor & Taylor, 2007:2). These amounts are usually settled through shares which satisfies the objective of aligning the employees' interests with that of the shareholders. Refer to chapter 3.2.1.3 for a discussion on SAR. A further development is the use of trusts in new equity based incentive schemes. This is discussed in the section below.

4.3.3.1 The use of trusts

In BPR 021 a trust was formed which would own the shares in the company prior to the participants obtaining ownership through the scheme. In another scheme, known as share incentive trusts, ownership of the shares does not pass to the participants but rather the participants have a vested right in the gains of the trust once the shares are sold. The participants receive units which represent the number of 'vested rights' that they have in the potential gains of the trust (Spamer, 2008:1).

Based on the expansion of the definition of 'equity instrument' in section 8C in 2008 it is clear that such a scheme will now fall within the ambit section 8C and any gains relating to the units will therefore be taxed upon vesting in the participant (Spamer, 2008:2). The units are usually restricted as they will not be freely tradeable and therefore will not vest as long as the trust remains active. Therefore it would seem that no tax consequence under section 8C exist as long as the trust is active.

There seems to be a separation between the vested right of the beneficiary in the income or capital gains of the trust and the vesting of the unit (equity instrument) in the participant. According to Spamer (2008:3) section 8C does not make reference to income received by beneficiaries of trusts and therefore the normal income tax rules applicable to trusts will be relevant. This would mean that the beneficiaries will be taxed in accordance with the 'conduit principle' as discussed in chapter 3.2.1.4 above and not under section 8C. In effect, income and capital gains received by the trust will be deemed to have accrued to the beneficiaries (Spamer, 2008:3).

Assuming that the trust does not receive any income it can be argued that the participants will only be taxed once the trust sells its shares and a gain realises. At this point the

beneficiaries (or participants) will, in accordance with the 'conduit principle' be deemed to have received a capital gain which will be taxable at their applicable capital gains tax rates (Spamer, 2008:3). It is argued that no tax exist under section 8C as the units did not vest.

In essence it would seem that the above scheme is successful in circumventing the objective of section 8C as the gains relate to the appreciation in share value but are not subject to normal income tax. Some queries, as discussed below arise as to the application of section 8C on this type of scheme.

According to the amendments to section 8C in 2008 it is clear that the units should fall within the ambit of the definition of equity instrument as it relates to "any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member's interest". The first question is whether the gain as described above (from the sale of the shares by the trust) is received as a result of being the owner of the unit or having a vested right in the gains of the trust?

Should it be argued that it is as a result of the unit it would seem that there would be no tax effect as the unit (equity instrument) has not vested, even though income has been received, based on the unit. Apart from the fact that no tax is payable this does not seem like a fair representation as it is clear that the unit is the equity instrument but that the income in this regard does not originate from the unit but rather from the vested right that the participant has in the trust.

According to subsection (3)(b)(v) of section 8C a restricted equity instrument vests if it is disposed of as per subsection (2)(a)(i) of section 8C. Subsection (2)(a)(i)(bb) refers to a disposal "by way of a release, abandonment or lapse" of equity instruments mentioned in paragraph (a) (options) and (b) (convertible financial instruments) of the definition of equity instruments. The question is whether subsection (3)(b)(v) should include the new paragraph (c) of the definition of equity instrument and whether the sale of the shares by the trust would imply that the contractual rights or 'units' have in effect been disposed of by way of release, abandonment or lapsing. Is the unit not released, or lapsed once the share that gives it its value is disposed of?

As it currently stands paragraph (c) of the definition of equity instrument does not form part of subsection (3)(b)(v). However it is deemed that should it be included, and the wording “release, abandonment or lapse’ is altered if necessary to ensure that it includes the disposal of the underlying shares relating to a contractual right as contemplated in paragraph (c) of the definition, the gains would be subject to section 8C and therefore be included in normal income.

It could also be asked whether the sale of the underlying share by the trust could imply the termination of the unit held by the participant to the scheme? Even though the word terminate does seem to have a limited meaning and may not include this scenario, the unit is in effect worthless if there is no underlying shares in the trust. Therefore the action that results in the unit to become worthless may imply termination. If so, under subsection (3)(b)(iv) of section 8C, the equity instrument (unit) would have vested at the date of disposal of the shares but only if subsection (3)(b)(iv) is expanded to include equity instruments as contemplated under paragraph (c) of the definition of equity instrument. Currently only paragraph (a) and (b) are included, similar to the argument above.

The question could also be raised whether subsection (5)(b) of section 8C is not applicable? Spamer (2008:3) notes that companies need to be careful when implementing the scheme in order to ensure that subsection (5)(b) is not applicable. The subsection applies to equity instruments acquired by a person as a result of the employees’ employment or directorship and will result in a deemed disposal by the employee as contemplated in subsection (5)(a). This would result in the employee or participant to be deemed to have sold the share, and not the trust. Therefore the gain would vest in the participant and be taxed under section 8C in the hands of the participant.

Finally, it may not be clear what would happen when the trust is wound up. If the unit (equity instrument) has not vested until such date and the gains from the disposal of the share by the trust have been taxed as capital gains, the wounding up could result in double taxation. It could be argued that the winding up of the trust falls within the ambit of subsection (3)(b)(iii) (vesting after termination) should the paragraph be expanded to include the new paragraph (c) of the definition of equity instrument or it could fall under subsection (3)(b)(v) (“release, abandonment or lapse”), once again, if it is expanded to

include paragraph (c) of the definition. In essence, the units will cease to exist once the trust is wound up and this could result in the vesting of the units as indicated above.

It would seem that even though double taxation may exist it would be limited because the trust would probably have sold all its shares prior to being wound up and therefore the units would have no value. In such a case it could even result in the participant having a tax loss to be deducted from normal income as the unit's value could be less than its initial value. This could result in unfair tax consequences as the participant will only be taxed at his applicable capital gains tax rate on the gains from the disposal of the shares but then have a deductible tax loss under section 8C if the units vest after the trust has been wound up and the units have no value.

4.4 CONCLUSION

In general it seems that the impact of section 8C on companies is twofold. Firstly companies need to review their current equity based incentive schemes and ensure that they are in compliance with section 8C and its amendments since introduction. This will include a review of their administrative system relating to the tracking of vesting dates.

Only if all equity instruments are identified and recorded and all restrictions are determined and properly tracked, will companies be able to effectively identify all vesting dates. This will ensure that companies are in a position to pay all applicable employees' tax and avoid the potentially significant penalties and interest resulting from non compliance.

Secondly, companies need to consider all the underlying factors when deciding on a new incentive structure. These factors will not only include the tax consequences of section 8C for both employer and employee but also the impact that it will have on the companies ability to retain key employees and directors as well as aspects such as share dilution.

It is also clear that companies will continue to draft equity based incentive schemes with the objective of circumventing section 8C. Therefore further amendments to the section are deemed to be likely which could also include guidance from the courts. Chapter 5 will focus on the results of the questionnaires as completed by tax specialists in practice.

CHAPTER 5 - ANALYSIS OF RESULTS FROM THE QUESTIONNAIRE

5.1 INTRODUCTION

In order to obtain further information and specifically the views of tax specialists in private practice a questionnaire was compiled with questions regarding potential problem areas as discussed during the previous chapters.

Bearing in mind the potential areas of misinterpretation or interpretative differences that may exist between companies, tax specialists and SARS it is important to seek information from tax specialists that work with companies on a frequent basis and thereby have knowledge and experience of actual problems or challenges in practice.

Equity based incentive schemes are not only found in large and/or listed companies but is certainly popular amongst the larger companies especially if the company's equity value is determined publicly on a stock exchange. Therefore it was deemed better to provide the questionnaire to tax specialists within the bigger audit companies including the so called 'big four'.

Of the nine questionnaires sent out four were received back in full and one participant only answered selected queries. Of the five participants three were from the big four audit companies, one from a large audit company and one outside the audit environment. All the participants are in a management position and are based in Gauteng. No specific reason for selecting Gauteng offices other than the fact that all large audit and law firms have offices in Gauteng and it is the main business hub in South Africa. Therefore these firms work with a wide variety of clients.

An e-mail was sent to the participants containing an introductory letter and the questionnaire to be completed. In selected instances the e-mail was followed up with telephonic conversations in order to determine whether participation will occur.

The questionnaire consists of three sections namely:

- General application of section 8C.
- The tax event.

- The potential impact of section 8C.

This chapter will provide the outcome of the questionnaires in order to determine whether similarities exist in the answers which could be an indication of potential problem areas or areas that could lead to interpretation differences.

5.2 ANALYSIS

5.2.1 General application of section 8C

Table 3: General application of section 8C

	Question	Strongly Disagree	Disagree	Impartial	Agree	Strongly Agree
Section 1 – General application of Section 8C						
1	The main purpose of Sec 8C was to ensure that all gains/appreciation of equity instruments as received under equity based incentives, are subject to income tax.		25%		50%	25%
2	The 'tax event' in Sec 8C is based on the principle of vesting whilst Sec 8A was based on the exercise, cession or release of any right to acquire any marketable security.				50%	50%
3	Whilst the <u>exercise</u> of a right to acquire a marketable security e.g. share option normally coincides with profit taking of the appreciation in the value of the share (cash movement) the <u>vesting</u> of share options do not necessarily bear such a link to actual profit taking i.e. the fact that the share option vests is no indication of the intent of the taxpayer to exercise the share option and 'take' the profit.				75%	25%
4	Sec 8A(1)(b) provided relief in certain cases where timing differences existed between the date that the shares were acquired and the date that the shares were sold. Sec 8C does not provide such relief based on a difference between the date of vesting and the date that the shares are actually sold.			25%	50%	25%
5	Sec 8C and specifically the timing of the tax event i.e. date of vesting, applies in the exact same				50%	50%

	Question	Strongly Disagree	Disagree	Impartial	Agree	Strongly Agree
	manner to profits and losses on the date of vesting.					
6	Share appreciation rights are only taxed as cash is received.	50%	25%		25%	
7	As per the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004, Sec 8C seeks to treat the receipt of all restricted equity instruments on par with 'share appreciation rights'.			75%	25%	
8	Share appreciation rights are taxed when the employee/director receives cash based on the increase of the corresponding equity value of the employer company.	25%	25%		25%	25%
9	The tax event in Sec 8C refers to the vesting of an equity instrument which may not correspond with the receipt of cash by the employee/director. Therefore it seems that a distinct difference exist between the timing of taxation according to Sec 8C and that of 'share appreciation rights'	25%	25%		50%	
10	In essence vesting can only occur on the exercise of equity instruments.	75%	25%			

1. The majority of participants (75%) agree that section 8C aims to include gains under equity based incentives in normal taxable income.
2. All participants agree that the new tax event under section 8C relate to the date of vesting whilst it related to the date of exercise, cession or release under section 8A.
3. All participants agree that even though the exercise of a right to acquire a marketable security normally coincides with profit taking, vesting does not necessarily bear such a link. In effect, all participants agree that vesting is no indication of the intent of the taxpayer to exercise the share option and 'take' the profit.
4. Apart from one impartial participant, everybody agreed that in contrast to section 8A, section 8C does not provide any relief based on a difference between the vesting date and the date that the equity instrument is actually sold.
5. All participants agreed that section 8C and specifically the date of vesting applies similarly to both profits and losses incurred.

6. Based on the responses, question 6 may have been unclear. In addition the taxing of share appreciation rights may have changed with the amendments to section 8C in October 2008 and therefore the comparison drawn between the taxing of equity instruments and share appreciation rights in the initial Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 may not be applicable anymore (refer to chapter 3.2.1.2 above). During the drafting of the questionnaire the purpose was to analyse the abovementioned comparison in the Explanatory Memorandum but due to the changes and the fact that share appreciation rights may also be equity settled the result of this specific analysis may be skewed. As a result, the majority of participants (75%) disagreed that share appreciation rights are only taxed as cash is received.
7. Refer point 6 above which is deemed why the majority of participants (75%) remained impartial as to the question whether section 8C seeks to treat the receipt of equity instruments on par with that of share appreciation rights.
8. Refer point 6 above which is deemed why the participants are divided on this question.
9. Even though 50% of the participants agree that there seems to be a distinct difference between the timing of the tax event between section 8C and that of share appreciation rights the comments under point 6 above should be noted.
10. All participants disagreed that vesting can only occur on the exercise of equity instruments. The essence of the question was rather that vesting can only occur on the exercise of exercisable equity instruments. Unfortunately the question did not contain this limitation and referred to equity instruments which could have impacted the answers as equity instruments do exist for which no exercise is necessary e.g. restricted shares.

5.2.2 The tax event

Table 4: The tax event

	Question	Strongly Disagree	Disagree	Impartial	Agree	Strongly Agree
	<u>Example 1:</u>					



	Question	Strongly Disagree	Disagree	Impartial	Agree	Strongly Agree
	<ul style="list-style-type: none"> Director receives a grant of 100 share options allowing him to exercise the options (acquire shares in the company) after 3 years at a cost of R10 per share. The market value of the shares is R50 per share in year 3. The director only exercises the options in year 6 when the market value of the shares is R100. 					
1	Profit of R40 per share will be included in the director's taxable income in Y3 even though no actual profit (cash) has been received.				67%	33%
2	The PAYE is payable in Y3 and the employer will be responsible to pay over the PAYE to the Receiver of Revenue.				67%	33%
3	The director could be in a position where he has to exercise <u>and</u> sell some of his share options in Y3 in order to fund the PAYE on the profits.	33%			67%	
4	No relief exists in Sec 8C for a delay in the payment of the tax until the shares are sold.				67%	33%
5	If the purpose of the equity share scheme is to motivate the employees/directors through their shareholding in the company i.e. encourage shareholding, the taxation of the options upon vesting may negatively impact on the ability to retain the shares i.e. the director may have to sell his shares in order to pay the taxes.				67%	33%
6	If the employees/directors envisage significant growth in the company due to strategies and plans implemented by them and the growth will probably lead to significant increases in the share price from Y4 onwards, the taxability in Y3 may result in an 'economically unfeasible' (financially senseless) decision to sell.				67%	33%
7	Employer companies are paying over the PAYE even though the options (e.g. share incentive schemes) have not been exercised i.e. the employee/director has not received any cash.		67%		33%	
8	Should the market value of the share price drop to R10 in Y6 the director would have paid Income tax at 40% on the gains in Y3, but can only claim the loss in Y6 as a capital loss (CGT) at an effective rate of 10%. This will result in a negative net cash flow for the director even though no real profits were received.			33%	67%	
	<p><u>Example 2:</u></p> <ul style="list-style-type: none"> Similar scenario as example 1 but price in Y3 is R5. 					



	Question	Strongly Disagree	Disagree	Impartial	Agree	Strongly Agree
9	The director will have a loss of R500 in Y3 even though the options were not exercised.		33%		33%	33%
10	The loss will not be ring fenced and should therefore, under normal circumstances, be deductible from the director's taxable income.				50%	50%
11	Based on the fact that significant numbers of options are issued to directors in many cases tax losses may result whilst no cash was actually paid or lost by the director.		33%		33%	33%
12	Should the value of the shares increase after Y3 the gains will only be subject to capital gains tax which would be at a net rate of 10% in most cases for the directors.			33%	67%	
13	It may be possible for a company that is aware of a potential decrease in its share value to issue share options, thereby 'creating' tax losses for their directors. Subsequent gains will only be subject to capital gains tax at a lower rate than the income tax applicable to the loss.			100%		
	<p>Section 8C provides detail of when an equity instrument is regarded as a restricted equity instrument impacting on the date of vesting. Par (b) of this definition states that an equity instrument will be regarded as a restricted equity instrument when it 'is subject to any restriction that could result in the taxpayer forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value'.</p> <p>Example 3:</p> <ul style="list-style-type: none"> • Similar scenario as example 1. • The director will forfeit his right to acquire shares (options) should he resign from the company and he has not exercised the options by the date of resignation. 					
14	The restriction mentioned above will result in the director not being taxed in Y3 as he may still forfeit the options should he resign i.e. there is a restriction that could result in the taxpayer forfeiting ownership.	33%			33%	33%
15	In order to avoid employees/directors paying tax upon the date of vesting companies can just add a restriction to the share option as per the example.			33%	33%	33%
	<p>Example 4:</p> <ul style="list-style-type: none"> • Similar scenario as example 3. • The director will forfeit his right to acquire shares (options) should he resign from the company and he has not exercised the options. However, upon resignation the director has 3 months after the date of resignation to exercise his options. 					



	Question	Strongly Disagree	Disagree	Impartial	Agree	Strongly Agree
16	The fact that the director has 3 months in order to exercise his options even if he resigns nullifies the restriction and therefore the shares will vest and be taxed in Y3.	33%	33%	33%		
17	The restriction remains in tact as the director might still forfeit his options if he does not respond within 3 months.			33%	33%	33%
18	Based on the example above the definition of a restriction and the application of this section may require further clarification as no case law currently exists on the matter.				67%	33%
19	The request for a Binding Private Ruling (refer BPR no. 21) is indicative of the fact that doubt exists regarding the validity of restrictions and the date of vesting.				67%	33%
20	The risk exists that companies may have restrictions within their share option plans which may not be regarded as 'valid restrictions' according to the Receiver of Revenue. Therefore companies may be liable for the taxes upon vesting of the share options but are currently not paying the taxes.		33%		67%	
21	The risk exists that companies are unaware of the implications of Sec 8C and made no changes to their share incentive plans. As a result they may not pay over the necessary taxes (PAYE) upon vesting of the shares.				100%	
22	To ensure accurate and complete implementation of the provisions of Sec 8C certain changes may be necessary in order to clarify potential grey areas in the section.			33%	33%	33%
23	Case law will result in further changes to Sec 8C in the future.			33%	67%	
24	Sec 8C is effective in subjecting profits or losses from equity based incentives (such as share incentive schemes) to normal income tax.				100%	
25	Sec 8C and specifically the timing of the tax event (vesting) and payment of taxes are fair in all circumstances.		100%			

1. All participants agreed that the profit will be included in the director's taxable income in year 3.

2. All participants agreed that the PAYE is payable in year 3 and that the employer will be responsible to pay over the amount.
3. The majority (67%) of the participants agreed that the director may be in a position where he has to sell some of his share options in order to fund the PAYE payable. Interesting to note is that one participant indicated that PAYE is only payable to the extent of cash remuneration in the year of vesting and is therefore not applicable to this scenario.
4. All participants agreed that no relief exists in section 8C for a potential delay in the payment of the tax until the share options are sold.
5. All participants agreed that the taxation of options upon vesting may have a negative impact on the ability of share scheme participants to retain their shareholding as they may be obligated to sell as a result of the tax consequences.
6. All participants agreed that the taxability in year 3 may result in an economically or unfeasible decision to sell especially if significant growth is envisaged for the company (and its share price).
7. The majority of participants (67%) disagreed that companies are paying over the PAYE even though the share options have not been exercised. Even though one comment was received that in practice most share options would be restricted until the date of exercise this response could be an indication that PAYE are currently not paid in time.
8. 33% of the participants remained impartial because the tax would be dependable upon the intention of the taxpayer. It is then assumed that the answer would have been positive (agreed) should the intention of the taxpayer be of a capital nature. All the other participants agreed (67%) the director would be in a negative net cash position even though no real profits were received.
9. The majority of the participants (67%) agreed that the director would have incurred a loss. Interesting to note that one participant who disagreed commented that no cost was incurred on receipt of the options, and options cannot have a negative value. In addition it was commented that only gains can therefore be possible if options vest i.e. losses not possible upon vesting and only possible upon exercise.
10. All participants who answered the question agreed that the loss will not be ring fenced and therefore will be deductible from the director's taxable income. The participant who disagreed with question 9 above did not answer question 10.

11. The majority of participants (67%) agreed that tax losses may exist in many cases whilst no cash was actually paid or lost by the applicable directors. The comments provided by one participant under question 9 above should be noted.
12. The majority of participants (67%) agreed that gains after year 3 would only be subject to capital gains tax.
13. All participants remained impartial on this question. The comments provided under question 9 above were repeated and another participant made a similar comment asking whether an option can have a negative value. It would seem that uncertainty exist in this regard.
14. The majority of the participants (67%) agreed that the director will not be taxed in year 3 due to the restriction. It is surprising to note that one participant strongly disagreed with the question but unfortunately no comments were provided.
15. The majority of participants (67%) agreed that in order to avoid paying tax early (in year 3) companies can add a restriction to the share option.
16. The majority of the participants (67%) disagreed that the restriction would be nullified by allowing the director to exercise his options three months after resignation.
17. The majority of participants (67%) agreed that the restriction will remain in tact.
18. All participants agreed that the definition of a 'restriction' and the application of this section (of section 8C) may require further clarification especially since no case law currently exists on the matter.
19. All participants agreed that the request for a binding public ruling (BPR 021) is indicative of the fact that doubt exists regarding the validity of restrictions and the date of vesting. The fact that all participants agreed to question 18 and 19 is a strong indication that interpretation differences may exist and that further clarification may be necessary.
20. The majority of participants (67%) agreed that companies may have restrictions in their share option plans that may not be 'valid' and that companies may therefore not be paying the necessary taxes upon vesting.
21. All participants agreed that companies may not be aware of the implications of section 8C and made no changes to their share incentive plans and that this may result in the non payment of taxes upon the vesting dates. In conjunction with the responses to 18 and 19 above this may be a cause for concern in the application of and compliance to section 8C.

22. The majority of participants (67%) agreed that in order to ensure accurate and complete implementation of section 8C certain changes may still be necessary in order to clarify potential grey areas in the section.
23. The majority of participants (67%) agreed that case law will result in further changes to section 8C in the future.
24. All participants agreed that section 8C is effective in subjecting profits or losses from equity based incentives to normal income tax.
25. However, all participants disagreed that section 8C and specifically the timing of the tax event (vesting) and payment of taxes are fair in all circumstances.

5.2.3 The potential impact of section 8C

Table 5: Potential impact of section 8C

	Question	Strongly Disagree	Disagree	Impartial	Agree	Strongly Agree
Section 3 – The potential impact of Sec 8C						
1	Sec 8C should have a significant impact on the structuring of equity based incentives.				50%	50%
2	Most companies have already altered their equity based incentives in order to avoid the tax implications of Sec 8C.		25%	25%	50%	
3	Companies have not altered their equity based incentives because they are unaware of the implications of Sec 8C.		50%	25%	25%	
4	Companies are aware of the implications of Sec 8C but are awaiting further clarification through case law before they will act.		50%	25%	25%	
5	The risk exists that companies are not tracking the vesting dates of share options e.g. do not have the administrative system in place to track all options and their vesting dates in order to ensure the timely payment of taxes (PAYE).				75%	25%
6	The average retention of equity by employees/directors on vesting date will decrease as a direct result of Sec 8C.		25%	25%	50%	
7	New equity based incentive schemes already exist that 'bypass' section 8C and therefore result in a more favourable tax position i.e. the full appreciation of the underlying equity instrument is not subject to normal income tax.			75%	25%	

1. All participants agreed that section 8C should have a significant impact on the structuring of equity based incentives.
2. There seems to be a divide on whether most companies have altered their equity based incentives in order to avoid the tax implications of section 8C. However, 50% of the participants agreed that most companies have altered their schemes.
3. Similar to question 2 there is also a divide on whether companies have not altered their equity based incentives due to unawareness of the implications of section 8C. However 50% of the participants disagree with the statement.
4. 50% of the participants also disagreed that companies are awaiting further clarification through case law before they will act, even though they are aware of the implications of section 8C.
5. All participants agreed that the risk exists that companies are not tracking the vesting dates of share options (e.g. do not have the administrative system in place to track options and their vesting dates) in order to ensure timely payment of the relevant taxes. Once again this could be a cause of concern as all participants agreed that companies may be lacking in this regard.
6. 50% of the participants agreed that equity retention on vesting date will decrease as a direct result of section 8C.
7. 75% of participants decided to remain impartial to the question whether new equity based incentives already exist that 'bypass' the provisions of section 8C and therefore result in a more favourable tax position. 25% did however agree that such schemes already exist.

5.3 CONCLUSION

As soon as the feedback from a questionnaire is more or less equally divided it is difficult to assess and even more difficult to draw any conclusions. However, once all participants agree or disagree to a question, especially if the participants are regarded as tax specialists who work with third party clients on a daily basis, it is fair to assume that such feedback should be fairly indicative of the general opinion and practice. Therefore, based on the results of the questionnaires there are selected statements or areas within the application of section 8C that raises concern.

Firstly, with reference to the general application of section 8C (section 1 of the questionnaire), there seems to be agreement that the vesting of an equity instrument bears no link to the intention of the taxpayer to exercise his 'options' or realise his gains. In addition, in contrast to section 8A, it is agreed that no relief is available in section 8C should the vesting date be prior to the date of disposal.

Secondly, with reference to the tax event (section 2 of the questionnaire) there was agreement that tax (PAYE) is payable once the equity instruments vest and that this may result in participants to a scheme not being able to retain their shareholdings and/or make economically unfeasible decision to sell even though they are aware of potentially significant growth in the company and its share price.

It was mostly agreed that a taxpayer could be in a position where he has a net outflow of cash for tax purposes even though he made a net loss on the equity instruments. This is possible because the taxpayer is taxed at the normal rate (e.g. 40%) once the equity instrument vests but can only deduct a subsequent loss at the capital gains tax rate (e.g. 10%) should the underlying equity instrument have lost value since the date of vesting.

In addition participants agreed that the losses incurred as per the example would not be ring fenced and are fully deductible from taxable income. Participants were also in full agreement that the principle of 'restrictions' and the application thereof may require further clarification and that the recent request for a binding public ruling (BPR 021) is indicative of the doubt that exists regarding the validity of restrictions and the date of vesting.

All participants also agreed that companies may not be aware of the implications of section 8C and made no changes to their share incentive plans and that this may result in the non payment of taxes upon the vesting dates. In conjunction with the responses to 18 and 19 above this may be a cause for concern in the application of and compliance to section 8C.

However, the participants felt strongly that section 8C is effective in subjecting profits or losses from equity based incentives to normal income tax but in the same breath unanimously disagreed that section 8C and specifically the timing of the tax event (vesting) and payment of taxes are fair in all circumstances.

With regards to the last section of the questionnaire, namely 'the potential impact of section 8C', it was agreed that section 8C will have a significant impact on the structuring of equity based incentives. It was also agreed by all participants that companies may not be tracking the vesting dates of share options effectively (e.g. do not have the administrative system in place to track options and their vesting dates) in order to ensure timely payment of the relevant taxes.

The feedback on the questionnaires is indicative of the fact that potential grey areas exist within section 8C and that interpretation differences may still have to be resolved. In addition there is doubt as to whether all companies are currently in compliance with the provisions of the section.

CHAPTER 6 - CONCLUSION

The research objectives of this study stated the following:

- To critically analyse the definitions of ‘vesting’ and ‘restricted equity instruments’ as provided in section 8C and to identify possible problem areas with the application of the terms in practice.
- To obtain information from tax practitioners regarding the interpretation and application of section 8C by taxpayers in practice, and to identify specific potential problem areas.

In the study the objectives were reached as follows:

- The terms ‘vesting’ and ‘restricted equity instruments’ were critically analysed in chapter two and three.
- Potential problem areas with the application of section 8C by companies were identified and analysed in chapter four.
- Information regarding the interpretation and application of section 8C were obtained from tax practitioners in chapter 5 and potential problem areas were identified.

Section 8C was introduced into the Act mainly in order to close the loopholes that existed under section 8A. In agreement with the feedback received from the tax practitioners it is argued that section 8C is effective in achieving this objective even though the section will have to be amended as companies conjure up new schemes.

What makes the section rather complex and difficult to interpret and apply is the introduction of a new tax event namely ‘vesting’ and new terms such as ‘restricted equity instruments’. During the analysis aspects regarding the determination of the date of vesting as well as the definition of restricted equity instruments were identified and analysed which may be regarded as potential grey areas or areas where misinterpretation could occur. This was also confirmed by the feedback received from the tax practitioners.

Of concern is also the fact that companies may not be aware or not be geared for the impact and requirements of section 8C. This relate to the fact that the section may result in significant changes to the date that equity instruments should be taxed together with the corresponding responsibility of the employer to withhold employees' tax. Furthermore the section could place a heavy administrative burden on companies to track vesting dates depending on the complexity of their equity based incentive schemes.

It is argued that further amendments will be made to the section in order to clarify certain aspects and close potential loopholes utilised by companies. This, together with guidance from potential case law should ease the use and interpretation of section 8C and ensure that no employees receive a tax benefit because of participation in an equity based incentive scheme.

What is sure is that section 8C had a significant impact on equity based incentive schemes and, if not already performed, companies should review their schemes and ensure compliance with the section.

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