

SHARE-BASED COMPENSATION: AN INVESTIGATIVE STUDY INTO THE TAXATION TREATMENT THEREOF INTERNATIONALLY

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ILSE BUYS

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Study leader: Johann Benade

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ABSTRACT

SHARE-BASED COMPENSATION: AN INVESTIGATIVE STUDY INTO THE TAXATION TREATMENT THEREOF INTERNATIONALLY

by

ILSE BUYS

SUPERVISOR : JOHANN BENADE

DEPARTMENT : TAXATION

DEGREE : MAGISTER COMMERCII

In terms of IFRS 2 (Share Based Payments), companies providing share based benefits to its employees have to include in its income statement, as an expense, an amount in respect of the share based benefits so provided. However, in South Africa no tax deduction is currently allowed for companies in respect of this share based compensation expense whilst the employee is typically subject to taxation on any gain made as a result of the shares acquired.

The research question that drove this study was whether the above taxation treatment is in line with practices followed internationally. For this purpose the tax legislation in the UK and Australia was explored in more detail. It was found that although tax legislation governing share-based compensation in South Africa are in some ways in line with practices implemented internationally, for most parts it still appears to be far more restrictive than legislation internationally.

OPSOMMING

AANDEEL GEBASEERDE KOMPENSASIE: 'N ONDERSOEKENDE STUDIE NA DIE BELASTING HANTERING DAARVAN INTERNASIONAAL

deur

ILSE BUYS

STUDIE LEIER : JOHANN BENADE

DEPARTEMENT : BELASTING

GRAAD : MAGISTER COMMERCII

Ingevolge IFRS 2 (Share Based Payments) moet maatskappye wat aandeel gebaseerde voordele aan hul werknemers verskaf die bedrag van die voordele so voorsien as 'n uitgawe in hul inkomstestaats erken. Geen belasting aftrekking word egter in Suid Afrika toegelaat vir die aandeel gebaseerde uitgawe so erken nie, terwyl die werknemer gewoonlik belas word op enige voordeel ontvang.

Die navorsingsvraag wat hierdie studie gedryf het was of die bogenoemde belasting hantering in lyn is met praktyke wat gevolg word internasionaal. Vir hierdie doeleinde was die belasting wetgewing van die Verenigde Koninkryke en Australië bestudeer. Die studie het gevind dat, alhoewel die belasting wetgewing in Suid Afrika in sommige opsigte in lyn is met praktyke wat gevolg word internasionaal, die wetgewing in Suid Afrika vir die grootste gedeelte daarvan meer beperkend is as die belasting wetgewing internasionaal.

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CHAPTER 1

INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

In terms of IFRS 2 (Share Based Payments), companies providing share based benefits to its employees have to include in its income statement, as an expense, an amount in respect of the share based benefits so provided, i.e. the share based compensation expense. However, in South Africa no tax deduction is currently allowed for companies in respect of this share based compensation expense, i.e. the issue of shares (or the right to acquire shares) in return for services rendered, due to the fact that the issue of shares is not regarded as “expenditure actually incurred” for purposes of the general deduction formula contemplated in section 11(a) of the Act (58/1962). However, should the company have paid its employees in cash in order to enable them to acquire shares in the company, the cash payment would typically have been deductible for taxation purposes in terms of section 11(a) of the Act (58/1962).

The issue whether the issue of shares constitute “expenditure actually incurred” for purposes of the Act (58/1962) has been considered in various local and international court cases. In **ITC 1783 (66 SATC 373)**, Goldblatt J held that the allotment or issuing of a company’s shares does not represent expenditure actually incurred, for purposes of section 11(a) of the Act (58/1962), as it does not in any way reduce the assets of the company. It merely reduces the value of the shares held by its shareholders.

The outcome of the abovementioned judgement was however widely criticised and many tax professionals, such as Ger (2004:61) and Burt (2004:133), indicated that they believed that the judge’s interpretation of the term “expenditure actually incurred” was too narrow and thus, that the conclusion reached by him was not entirely correct, having specific regard to foreign authority on the matter. This view was confirmed in a subsequent case, **Income Tax Special Court Case no 11024** where it was held by Jooste, AJ that, based on an analysis of the reasoning in English and South African case law, the decision reached in **ITC 1783 (supra)** was clearly wrong and not a reflection of the law.

As a result of this ongoing debate regarding whether the issue of shares constitute “expenditure actually incurred” for purposes of the general deduction formula, SARS, during 2004, introduced section 24B into the Act (58/1962). In terms of this section, the issue of shares in return for the acquisition of goods or an asset is deemed to be “expenditure actually incurred” equal to the market value of the asset acquired. The provisions of section 24B of the Act (58/1962) however only apply to the issue of shares in return for an asset. Therefore, although the introduction of this section was arguably meant to clarify the matter, the section does not deal with instances where shares are issued to employees in respect of services rendered and accordingly, no certainty has been obtained in this regard.

In addition, the disallowance of a deduction for share based compensation in the hands of the employer whilst the employee would typically be subject to taxation on any gain made as a result of the shares acquired seems unfair. One would expect some sort of tax relief for the employee, seeing that the company is not entitled to a tax deduction in respect of the shares issued.

Having regard to the prevalence of share-based compensation in the corporate environment today as well as the significance of the amounts involved, it is surprising that so little thought has been given to finding an alternative mechanism to tax these amounts in South Africa or, alternatively, to challenge the accuracy of the current taxation treatment thereof in light of the international treatment thereof.

Currently, in terms of section 11(A) of the Act (58/1962), South African companies are, subject to certain strict requirements, entitled to a maximum deduction of R10 000 per employee per annum in respect of the market value of equity shares issued to the particular employee in respect of services rendered. To the extent that the market value of the equity shares issued to an employee during a specific year of assessment exceeds the annual threshold of R10 000, the excess may be carried forward to be deducted in the following year of assessment, taking into consideration the aforementioned threshold. This deduction is however only available in respect of broad-based employee share plans (as envisaged by section 8B of the Act (58/1962)), i.e. share incentive plans where at least 80 per cent of full time employees are entitled to participate and where other strict

requirements are met. It thus excludes share incentive plans focusing primarily on incentivising middle and senior management only.

It is submitted that the annual threshold of R10 000 per employee is not representative of the actual market values of equity shares being issued to employees as compensation for services rendered in the business environment today. For example, the following amounts represent the share-based compensation expense, recognised for accounting purposes in terms of IFRS 2 (Share based payments), by some of the largest companies in South Africa:

- FirstRand Limited – R455 000 000 (FirstRand Limited, 2008);
- AngloGold Ashanti Limited – \$31 000 000 (AngloGold Ashanti Limited, 2007);
- SABMiller plc - \$52 000 000 (2008) (SABMiller plc, 2008);
- Sanlam – R91 000 000 (Sanlam, 2007).

The purpose of this document is to explore the international treatment of share based compensation from both the employer and the employee's perspective, in order to determine whether the treatment thereof in South Africa is in line with international practices.

1.2 RESEARCH QUESTION

The core research question that will guide this study is the following:

“Is the current taxation treatment of share based compensation in South Africa, from both an employer and employee perspective, in line with practices followed internationally?”

1.3 RESEARCH OBJECTIVES

The study will be guided by the following specific research objective:

- To analyse whether the current taxation treatment of share based compensation in South Africa, from both an employer and employee perspective, is in line with international tax principles by performing a literature review of local and international tax legislation on the matter.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

Having regard to the prevalence of share based compensation in the business environment today (as discussed earlier), the proposed study will provide valuable insights into the treatment of share based compensation internationally and whether the treatment thereof in South Africa is in line with international practices. The existence of previous studies on the matter could not be confirmed and hence this study would be the first to compare the taxation treatment of share based compensation in South Africa to international practices.

1.5 DELIMITATIONS

The following is specifically excluded from the scope of this document:

- The taxation treatment of share incentive plans facilitated through a special purpose vehicle, i.e. a trust. The taxation implications of these type of share incentive plans may differ from the taxation implications of share incentive plans where shares or the right to acquire shares are issued by the company directly to its employees;
- The taxation treatment of share-based compensation in respect of the acquisition of goods or assets; and
- Employees' tax ("PAYE") considerations from both the employer and the employees' perspective.

1.6 ASSUMPTIONS

No specific assumptions were relied upon in this document.

1.7 RESEARCH DESIGN AND METHODS

The proposed study will be performed through a review of available local and international literature in respect of the taxation treatment of share-based compensation, from both the employer and employee perspective. Local and international tax legislation, guidance from revenue authorities, textbooks and information on the internet will be reviewed for this purpose.

1.8 DEFINITION OF KEY TERMS

This document involves a number of key concepts. It is submitted that these key concepts should be interpreted as follows:

Share-based compensation: Payments by a company by way of the allotment and issuing of its own shares, or the right to acquire its own shares at a future date, to an employee of the company as consideration for services rendered;

Employee(s): The employee receiving shares, or the right to acquire shares at a future date, in his or her employment company in return for services rendered;

Employer(s), company, companies or taxpayer(s): The company allotting or issuing shares, or the right to acquire shares at a future date, to its employees in return for services rendered by the employees;

General deduction formula: The provisions of section 11(a) of the Act (58/1962); and

Share incentive plans or employee share schemes: The particular plan or scheme through which the allotment or issuing of shares or the right to acquire shares in the company is facilitated.

The following abbreviations are used in the body text of this study:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
The Act	The Income Tax Act No 58 of 1962, as amended
CGT	Capital gains tax, as envisaged by the Eighth Schedule to the Act No 58 of 1962, as amended
Companies Act	Companies Act No 61 of 1973
HMRC	Her Majesty's Revenue & Customs
IFRS	International Financial Reporting Standards
ITAA 1936	Income Tax Assessment Act 1936
ITAA 1997	Income Tax Assessment Act 1997
ITC	Income Tax Court
ITEPA	Income Tax (Earnings and Pensions) Act

	2003.
SARS	The South African Revenue Service

1.9 STRUCTURE OF THE DISSERTATION

Chapter 1: Introduction and problem statement

Chapter 1 provides an introduction to the study and the research questions and objectives driving the study. It furthermore sets out the importance of the study, delimitations, key terms and the research methodology to be used to conduct the study.

Chapter 2: Overview of the taxation treatment of share-based compensation in South Africa

Chapter 2 provides an overview of the taxation treatment of share-based compensation in South Africa, having specific regard to the sections in the Act (58/1962) which deals with the taxation treatment of share-based compensation, i.e. section 8C and section 8B of the Act (58/1962). It furthermore includes a discussion on the application of the abovementioned tax legislation to share-based compensation.

Chapter 3: Overview of the taxation treatment of share-based compensation internationally

Chapter 3 provides an overview of the taxation treatment of share-based compensation internationally, focusing primarily on the tax legislation and principles applied in Australia and the United Kingdom.

Chapter 4: Conclusion

In Chapter 4 a conclusion is reached regarding whether or not the taxation treatment of share-based compensation in South Africa, from both an employee and employer perspective, is in line with principles applied internationally.

CHAPTER 2

OVERVIEW OF THE TAXATION TREATMENT OF SHARE-BASED COMPENSATION IN SOUTH AFRICA

2.1 INTRODUCTION

In order to recruit, retain and motivate employees, South African companies have, over the years, implemented various types of share incentive plans. These plans typically involve the issuing of shares or the right to acquire shares at a future date (i.e. share options) to employees in return for services rendered.

Based on a survey conducted of the top 80 listed companies in South Africa in 2008, 34% of these companies have implemented share option plans, whilst 23% has opted for restricted share plans (SAICA, 2009:21). Share option plans and restricted share plans are therefore clearly the most popular share incentive plans currently in South Africa.

In instances where employees are awarded shares, the shares are usually awarded contingent upon continued employment and/or on the achievement of certain individual, group or company performance targets and represents restricted equity instruments on the date of issue (i.e. the employee cannot freely dispose of these shares as yet). These plans represent restricted share plans. Once the employment and/or performance targets have been met, the shares vests in the employee, becomes unrestricted equity instruments, and the employee is able to freely dispose of the shares. On the vesting date, the employee is subject to taxation at its maximum marginal rates on the difference between the purchase price of the shares (if any) and the market value of the share, in terms of section 8C of the Act (58/1962). Should the employee disposes of the shares subsequent to the vesting date, the gain made on the disposal is subject to either CGT or normal income tax, depending on the circumstances and the intention of the employee. The employer company is not entitled to any deduction in respect of the shares issued to the employee in return for services rendered due to the fact that the issue of shares is not seen to constitute “expenditure actually incurred” for purposes of section 11(a) of the Act (58/1962). Furthermore, the Act (58/1962) does not provide for a specific tax deduction for the company in respect of the issue of the shares.

In instances where share options are granted to employees in return for services rendered, options are generally granted to selected employees to subscribe for shares in the company at a specified time in the future. These plans represent share option plans. The purchase price or subscription price payable for the shares is typically the market value of the shares at the time when the option is granted to the employee. The employee does not have to pay for the shares offered to him until he exercises the option. On exercise date, the employee will be subject to taxation on the difference between the strike price (typically the market value of the share on grant date) and the market value of the shares at the point of exercise (unless the underlying share is still subject to restrictions relating to its disposal, i.e. represents a restricted equity instrument, in which event there may be a delay in the taxing event). Should the employee dispose of the shares subsequent to the exercise date, the gain made on the disposal would be subject to either normal income tax or CGT, depending on the circumstances and the intention of the employee. Once again, the employer company is not entitled to a deduction in respect of the shares issued to the employee in return for services rendered as the issue of shares is not seen to constitute “expenditure actually incurred” for purposes of section 11(a) of the Act (58/1962). Furthermore, the Act (58/1962) does not provide for a specific tax deduction for the company in respect of the issue of the shares.

South African companies may also enter into broad based employee share plans as envisaged by section 8B of the Act (58/1962), in terms of which equity shares in that employer company are acquired by the employees for consideration which does not exceed the minimum consideration required by the Companies Act (61/1973). Any amount received by or accrued to an employee in the form of a qualifying equity share in terms of a broad based employee share plan is exempt from tax in terms of section 10(1)(nC) of the Act (58/1962). However, any gain realised on the subsequent disposal of the share would be subject to income tax in the hands of the employee by virtue of the provisions of section 8B(1) of the Act (58/1962).

As discussed in 1.1, section 11(IA) of the Act (58/1962) allows for a maximum deduction in the hands of the employer of R10 000 per employee per annum in respect of the market value of equity shares issued to the particular employee in respect of a broad based employee share plan. However, in order to qualify for this deduction, strict requirements need to be met, one of which is that at least 80 per cent of the full time employees of the

company must be entitled to participate in the scheme. Share incentive plans primarily focusing on incentivising middle and senior management will thus not qualify for this relief.

Below follows a more detailed analysis of the provisions of section 8B and 8C of the Act (58/1962).

2.2 SECTION 8B OF THE ACT

Section 8B of the Act (58/1962) governs the taxation treatment of equity instruments in the hands of employees where the equity instrument was obtained in terms of a broad-based employee share. Broad-based employee share plan is defined in section 8B(3) of the Act (58/1962) to mean a plan in terms of which-

- (a) equity shares in that employer, or in a company that is an associated institution as defined in the Seventh Schedule in relation to the employer, are acquired by employees of that employer, for consideration which does not exceed the minimum consideration required by the Companies Act (61/1973);
- (b) employees who participate in any other equity scheme of that employer or of a company that is an associated institution as defined in the Seventh Schedule in relation to that employer are not entitled to participate and where at least 80 per cent of all other employees who are employed by that employer on a permanent basis on the date of grant (and who have continuously been so employed on a full-time basis for at least one year) are entitled to participate;
- (c) the employees who acquire the equity shares as contemplated in paragraph (a) are entitled to all dividends and full voting rights in relation to those equity shares; and
- (d) no restrictions have been imposed in respect of the disposal of those equity shares, other than-
 - (i) a restriction imposed by legislation;
 - (ii) a right of any person to acquire those equity shares from the employee or former employee who acquired the equity shares as contemplated in paragraph (a) –
 - (aa) in the case where the employee or former employee is or was guilty of misconduct or poor performance, at the lower

- of market value on the date of grant or the market value on the date of acquisition by that employer; or
- (bb) in any other case, at market value on the date of acquisition by that person; or
- (iii) a restriction in terms of which the employee or former employee who acquired the equity shares as contemplated in paragraph (a) may not dispose of those equity shares for a period, which may not extend beyond five years from the date of grant.

Section 8B(1) of the Act (58/1962) stipulates the following:

“Notwithstanding section 9C, there must be included in the income of a person for a year of assessment any gain made by that person during that year from the disposal of any qualifying equity share or any right or interest in a qualifying equity share, which is disposed of by that person within five years from the date of grant of that qualifying equity share, otherwise than –

- (a) in exchange for another qualifying equity share as contemplated in subsection (2);
- (b) on the death of that person; or
- (c) on the insolvency of that person.”

“Qualifying equity share” is defined to mean an equity share acquired in a year of assessment in terms of a broad-based employee share plan, where the market value of all equity shares (as determined on the relevant date of grant of each equity share and excluding the market value of any qualifying equity share acquired in the circumstances contemplated in subsection (2A)), which were acquired by that person in terms of that plan in that year and the four immediately preceding years of assessment, does not in aggregate exceed R50 000.

“Gain” in relation to the disposal by a person of a qualifying equity share or a right or interest in a qualifying equity share, means in terms of section 8B of the Act (58/1962), the amount by which any amount received by or accrued to that person from that disposal exceeds the consideration given by him or her for that qualifying equity share, right or

interest (otherwise than in the form of services rendered or to be rendered or anything done or to be done or not to be done).

In addition, the provisions of section 8B of the Act (58/1962) override the provisions of section 9C of the Act (58/1962). Accordingly, the deemed capital rules in terms of section 9C of the Act (58/1962) would not apply to any gain realised on the disposal of a qualifying equity share within five years from the date it was obtained, i.e. the gain would always be subject to normal income tax (and not CGT). To the extent that the share is disposed of after five years, the gain will be subject to CGT at a lower rate.

Lastly, regard should be given to the provisions of section 10(1)(nC) of the Act (58/1962). Section 10(1)(cN) of the Act (58/1962) which stipulates that any amount received by or accrued to a person in the form of a qualifying equity share contemplated in section 8B of the Act (58/1962) would be exempt from tax. This would mean that on receipt of the share, the employee would not be subject to any tax.

From the employers perspective, section 11(IA) of the Act (58/1962) allows for a maximum deduction of R10 000 per employee per annum in respect of the market value of equity shares issued to the particular employee in respect of the broad based employee share plan.

From the above it is evident that section 8B(1) of the Act (58/1962) tax any gain made by an employee in respect of the disposal of any qualifying equity shares or any right or interest in a qualifying equity share, which is disposed of by that person within five years from the date of grant. The initial receipt of the qualifying share by the employee is however not subject to tax in terms of section 10(1)(nC) of the Act (58/1962).

The employer is furthermore, in terms of the provisions of section 11(IA) of the Act (58/1962), entitled to a maximum deduction of R10 000 per employee in respect of qualifying equity shares issued to the employee.

2.3 SECTION 8C OF THE ACT

The provisions of section 8C of the Act (58/1962) govern the taxation treatment of equity instruments in the hands of employees or directors where the equity instrument was or is

obtained after 26 October 2004 and was not obtained in terms of a broad based employee share plan as envisaged by section 8B of the Act (58/1962). Section 8A of the Act (58/1962) applied in respect of the exercise, cession or release of any right to acquire any marketable security if such right (i.e. option) was obtained by the employees or directors before 26 October 2004.

Effectively, section 8A of the Act (58/1962) provided for a tax liability on the day that the right was exercised or otherwise dealt with by the director or employee whereas section 8C (58/1962) provides for a tax liability on the day that the equity instrument vests in the employee or director.

Section 8C of the Act (58/1962) however replaced the provisions of section 8A of the Act (58/1962) with effect from 26 October 2004.

Section 8C(1) of the Act (58/1962) reads as follows:

“(a) Notwithstanding sections 9B, 9C and 23(m), a taxpayer must include in or deduct from his or her income for a year of assessment any gain or loss determined in terms of subsection (2) in respect of the vesting during that year of any equity instrument, if that equity instrument was acquired by that taxpayer –

- (i) by virtue of his or her employment or office of director of any company or from any person by arrangement with the taxpayer’s employer; or
- (ii) by virtue of any other restricted equity instrument held by that taxpayer in respect of which this section will apply upon vesting thereof.

(b) This section does not apply in respect of any equity instrument which

- (i) was acquired by the exercise or conversion of, or in exchange for the disposal of, any other equity instrument where this section applied in respect of the vesting of that other equity instrument before that exercise, conversion or exchange; or
- (ii) constitutes a qualifying equity share contemplated in section 8B.” (emphasis added).

In terms of section 8C(2)(a)(ii) and section 8C(2)(b)(ii) of the Act (58/1962), the gain or loss to be included in the income of the taxpayer is generally the amount by which the market value of the equity instrument determined at the time that it vests in that taxpayer exceeds or does not exceed the sum of any consideration payable in respect of that equity instrument.

An “equity instrument” is defined in section 8C(7) of the Act (58/1962) to mean a share or a member’s interest in a company, and includes

- (a) an option to acquire such a share, part of a share or member’s interest;
- (b) any financial instrument that is convertible to a share or a member’s interest;
and
- (c) any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member’s interest.

In terms of section 8C(3) of the Act (58/1962), an equity instrument acquired by a taxpayer is deemed to vest in that taxpayer-

- (a) in the case of the acquisition of an unrestricted equity instrument, at the time of that acquisition; or
- (b) in the case of the acquisition of a restricted equity instrument, at the earliest or-
 - (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.

Section 8C(7) of the Act (58/1962) defines a “restricted equity instrument” in relation to a taxpayer as an equity instrument which is, inter alia, subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of the equity instrument at market value.

In turn, section 8C(7) of the Act (58/1962) defines an “unrestricted equity instrument” as an equity instrument which is not a restricted equity instrument.

Section 8C of the Act (58/1962) also overrides, inter alia, the provisions of section 9B and 9C of the Act (58/1962). The provisions of section 9B of the Act (58/1962) only applies in respect of the disposal of “affected shares” before 1 October 2007 and have been replaced with the provisions of section 9C of the Act (58/1962) effective 1 October 2007. Accordingly, for purposes of this document regard will only be had to the provisions of section 9C of the Act (58/1962).

Section 9C of the Act (58/1962) effectively stipulates that the disposal of any equity share contemplated in section 44 (“qualifying share”) will be deemed to be of a capital nature, if the taxpayer immediately prior to such disposal had been the owner of that share for a continuous period of at least three years excluding a share which at any time during that period was –

- (a) a share in a share block company as defined in section 1 of the Share Blocks Control Act (58/1962), 1980;
- (b) a share in a company which was not a resident, other than a company contemplated in paragraph (a) for the definition of “listed company”; or
- (c) a hybrid equity instrument as defined in section 8E.

However, to the extent that the provisions of section 8C of the Act (58/1962) apply, the provisions of section 9C of the Act (58/1962), which deems the proceeds on the disposal of certain shares to be capital in nature, would not apply.

Following from the above, it is evident that the provisions of section 8C of the Act (58/1962) are triggered when equity instruments (which includes shares and share options) are obtained by a taxpayer by virtue of his employment or office as director and

the equity instruments so obtained vest during a particular year of assessment. It is thus clear that the taxing event in terms of section 8C of the Act (58/1962) is triggered when the equity instrument vests as opposed to when it is obtained or granted. Effectively, having regard to the provisions of section 8(C)(3) of the Act (58/1962), an equity instrument vests in a taxpayer when all restrictions in terms of that equity instrument are lifted, i.e the taxpayer obtain unrestricted access to the instrument (Silke, 2009:4.73C). Furthermore, in terms of section 8C(2) of the Act (58/1962), the amount to be included or deducted from the taxpayer's taxable income for that year is the difference between the market value of the equity instrument and the consideration payable by the taxpayer.

For example, an employer awards 100 shares to an employee at their market value of R500, subject to the condition that the employee is not permitted to dispose of the shares for a period of four years, which means that the shares are classified as restricted equity instruments. When the shares vest four years later, the employee will be taxed on the market value of the shares at that date, i.e. R700, even though he paid in full for the shares four years earlier (Silke, 2009:4.73C). Effectively the employee will be subject to taxation on an amount of R200, being the difference between the market value of R700 and the consideration payable of R500. Also, due to the fact that the provisions of section 8C of the Act (58/1962) overrides the provisions of section 9C of the Act (58/1962), the employee would not be entitled to the deemed capital rules in section 9C of the Act (58/1962) even though it held the shares for more than three years prior to the disposal thereof.

In terms of the provisions of section 8C of the Act (58/1962), no taxation is payable by an employee until such time that the equity instrument vests. This is furthermore confirmed by section 10(1)(nD) of the Act (58/1962) which stipulates that any amount received by or accrued to a person which constitutes

- (i) an equity instrument contemplated in section 8C acquired by that person and in respect of which that section applies; or
- (ii) consideration for the disposal of an equity instrument contemplated in subparagraph (i),

which had not yet vested as contemplated in that section at the time of that acquisition or disposal, is exempt from normal tax.

Only on the vesting of the equity instrument, is the employee thus taxed on any gain realised in respect of the acquisition of the equity instrument from its employer. In terms of section 8C of the Act (58/1962), no concessions or relief is available in respect of the taxation so payable. Should the employee dispose of the share subsequent to the vesting date, the employee will be subject to either normal income tax or capital gains tax on any gains realised, depending on the circumstances and the intention of the employee. To the extent that the disposal would be subject to capital gains tax, the market value of the shares on vesting date would constitute the base cost of the share in terms of paragraph 20(h)(i) of the Eighth Schedule to the Act (58/1962).

2.4 CONCLUSION

Based on the above analyses of the tax legislation of share based compensation in South Africa, it is evident that limited relief is currently available to employers and employees in respect of share based compensation.

In terms of section 8B of the Act (58/1962), employees are not subject to taxation on the initial grant of a share in terms of a broad based employee share plan. However, upon disposal of the shares so obtained, the employee would be subject to normal income tax on any gain realised, if the shares are disposed of within five years. The employer would however be entitled to a maximum deduction of R10 000 per year per employee in respect of shares issued in terms of a broad based employee share plan. However, in terms of section 8B(3) of the Act (58/1962) certain requirements need to be adhered to in order for a share incentive plan to constitute a broad based employee share plan. From an employers perspective, executive share incentive plans would typically not qualify for the deduction in terms of section 11(A) of the Act (58/1962).

In terms of section 8C of the Act (58/1962), employees are generally subject to income tax at marginal income tax rates when equity instruments awarded to them vest. Only disposals subsequent to vesting date could attract capital gains tax as opposed to normal income tax. Furthermore, although the employee is subject to normal income tax in respect of any gain realised on vesting date, the employer is not entitled to any deduction in respect of the gain realised by the employee.

CHAPTER 3

OVERVIEW OF THE TREATMENT OF SHARE BASED COMPENSATION INTERNATIONALLY

3.1 INTRODUCTION

The following table summarises the taxation treatment of share based compensation in the hands of the employer and the employee in various OECD countries (OECD, 2005):

Table 2: Overview of the treatment of share based compensation internationally

Type of scheme	Employee - Benefit taxed as ordinary income	Basis of valuation	Timing of taxation	Notes	Employer - Deduction for employee stock option compensation	Notes
Australia						
- Standard	Yes	Market value	Grant		No	When stock option are met with newly issued shares the company is not entitled to the deduction, it would be entitled for purchased shares (but this scenario is unlikely)
- Concessionary (1)	Yes	Net value	Exercise		No	
- Concessionary (2)	Yes	Net value (first AUD 1000 deducted)	Grant		No	
	Yes	Net value (exceeding AUD 1000)	Grant		No	
Austria						
- Standard	Yes	Net value (up to 50% tax exempt)	Exercise		No	
	Yes	Net value	Exercise		No	
Belgium						
- Concessionary	Yes	15% of value of shares	Grant		No	
	Yes	7.5% of value of shares	Grant		No	
Canada						
Concessionary (public company)						
- (i)	Yes	Net market value	Exercise		No	
- (ii)	Yes	50% of net market value	Disposal of shares (if certain conditions are met)		No	
Concessionary (private company)						
- (i)	Yes	Net market value	Disposal		No	
- (ii)	Yes	50% of net market value	Disposal		No	
Concessionary (phantom)						
- (i)	Yes	Market value of bonus paid	Year payment/ bonus is received		Yes	
- (ii)	Yes	50% of market value of bonus paid	Disposal		Yes	
Profit sharing plans	Yes	Value of contributions	Year they are made		Yes	



Type of scheme	Employee - Benefit taxed as ordinary income	Basis of valuation	Timing of taxation	Notes	Employer - Deduction for employee stock option compensation	Notes
Czech Republic						
- Standard	Yes	Net market value	Grant		Yes	If the stock options are sold or granted to employee not as part of work related remuneration they are not deductible.
Denmark						
- Standard	Yes	Market value	Exercise		Yes	
- Concessionary (1)	No	Net market value	Disposal	Benefit taxed as capital gain	No	
- Concessionary (2)	No	Net market value	Disposal	Benefit taxed as capital gain	Yes	
Finland						
- Standard	Yes	Net market value	Exercise		Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares, no deduction available.
France						
- Concessionary (1) – (3)	No	Net fair market value	Cash		Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares, no deduction available.
Germany						
- Standard (i)	Yes	Net market value (annual allowance)	Exercise		Yes	Provided that the employee pays personal income tax on the benefit
- Standard (ii)	Yes	Net market value	Exercise		Yes	Provided that the employee pays personal income tax on the benefit
Greece						
- Standard	Yes	Net fair market value	Exercise		Yes	
- Concessionary	Yes	Net fair market value	Exercise		No	
Hungary						
- Standard	Yes	Net market value	Exercise	Benefit not treated as ordinary employment income	No	
- Incentive pay scheme	No	Net value	Cash		No	
Iceland						
- Standard	Yes	Net market value	Exercise		Yes	However, there is no legislative provision as to the treatment of stock options in company accounts or in tax legislation as such.
- Concessionary	No	Net value	Disposal	Benefit taxed as capital gains	No	
Ireland						
- Standard	Yes	Net value	Exercise		No	



Type of scheme	Employee - Benefit taxed as ordinary income	Basis of valuation	Timing of taxation	Notes	Employer - Deduction for employee stock option compensation	Notes
- Concessionary (approved share options schemes)	No	Net market value	Disposal		No	Provided certain conditions are met benefits are taxed as capital gains. Exemption up to the annual limit applies.
- Concessionary (approved savings related share option scheme)	No	Net market value	Disposal			Provided certain conditions are met benefits are taxed as capital gains. Exemption up to the annual limit applies.
Italy						
- Standard	Yes	Net value	Grant		Yes	However, the deduction is not allowed from the regional corporate income tax (IRAP)
- Concessionary	No	Difference between sale price of share and strike price	Disposal	Benefits taxed as capital gains	Yes	
- Incentive pay scheme	No	Difference between sale price and value of the shares at grant	Disposal	Benefit taxed as capital gains	Yes	
Japan						
- Standard	Yes	Net market value	Exercise	However, provided certain conditions are met benefits are taxed as capital gains at the time of disposal of shares	Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares the company is not entitled to the deduction.
Korea						
- Standard	Yes	Net market value	Exercise		Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares the company is not entitled to the deduction.
- Concessionary	Yes	Net market value	Exercise		Yes	
Luxembourg						
- Standard					Yes	
- Options librement negociables	Yes	Net value	Grant			
- Options individuelles (i)	Yes	Net value	Exercise			
- Options individuelles (ii)	Yes	Net value reduced by 5% each year (until 20%)	Exercise			
Mexico						
- Standard	Yes	Net value	Exercise		Yes	The loss from the sale of stocks to the employee below market value, it is qualifies as a loss from a plain sale of stocks, is deductible for the corporation only against profits
- Profit sharing plans	Yes	Paid value (exemption up to 15 days of the minimum wage)	Cash		No	



Type of scheme	Employee - Benefit taxed as ordinary income	Basis of valuation	Timing of taxation	Notes	Employer - Deduction for employee stock option compensation	Notes
Netherlands						from other sales of stocks, with the possibility of carry forwards.
- Standard (1)	Yes	Economic value	Grant		Yes	The costs of the option at the moment of grant are deductible
- Standard (2)	Yes	Act (58/1962)ual obtained profit	Exercise			
New Zealand						
- Standard	Yes	Net market value	Exercise		No	
Norway						
- Standard	Yes	Net value	Exercise		Yes	When stock options are met with purchased shares
Poland						
- Standard	No	Net market value	Exercise		Yes	When stock options are met with purchased shares
Portugal						
- Standard	Yes	Net market value	Exercise		Yes	The costs are deductible if accounted for as staff costs.
Slovak Republic						
- Standard	No	Capital gains on shares	Disposal	Benefit taxed as capital gains	No	
Spain						
Standard						
- (i)	Yes	70% of net value	Exercise		Yes	Spanish companies can only obtain a corporate tax deduction provided the company incurred a real expense. Companies cant deduct the opportunity cost associated with issuing new shares.
- (ii)	Yes	100% of net value	Exercise		Yes	
Incentive pay scheme						
- (i)	Yes	Value (up to a minimum value of EUR 3005 per year)	Grant		Yes	
- (ii)	Yes	Value (exceeding EUR 3005 per year)	Grant		Yes	Spanish companies can only obtain a corporate tax deduction provided the company incurred a real expense. Companies cant deduct the opportunity cost associated with issuing new shares.
Sweden						
- Standard	Yes	Net market value	Exercise		Yes	
Switzerland						
- Standard	Yes	N/a	Exercise or grant		Yes	
Turkey						
- Standard	Yes	Market value	Grant		Yes	
UK						



Type of scheme	Employee - Benefit taxed as ordinary income	Basis of valuation	Timing of taxation	Notes	Employer - Deduction for employee stock option compensation	Notes
- Standard (unapproved schemes)	Yes	Net gain	Exercise		Yes	Automatic for accounting periods starting from 1 January 2003 of later. Only sometimes possible for earlier accounting periods using a case law deduction.
- Concessionary (CSOP, SAYE, EMI)	Yes	Net market value	Disposal	Assuming scheme conditions are met, benefits are taxed as capital gains determined as the difference between share disposal proceeds and the Act (58/1962)ual price paid for the shares, plus cost of option (if any). Annual exemption applies.	Yes	
- Share incentive plan (SIP)	No	Net market value	Disposal	Assuming scheme conditions are met, benefits are taxed as capital gains determined as the difference between share disposal proceeds and the Act (58/1962)ual price paid for the shares, plus cost of option (if any). Annual exemption applies.	Yes	
- Restricted share awards	Yes	Net gain	Acquisition and lifting of each restriction or sale, whichever is earlier	Assuming scheme conditions are met, benefits are taxed as capital gains determined as the difference between share disposal proceeds and the Act (58/1962)ual price paid for the shares, plus cost of option (if any). Annual exemption applies.	Yes	
- Convertible share awards	Yes	Net gain	Acquisition and lifting of each restriction or sale, whichever is earlier	Income Tax and Class 1 National Insurance Contributions liabilities at acquisition a proportion of value reflecting restrictions. Further liabilities when restrictions lifted on	Yes	



Type of scheme	Employee - Benefit taxed as ordinary income	Basis of valuation	Timing of taxation	Notes	Employer - Deduction for employee stock option compensation	Notes
				proportion of value released at that time. Employer and employee may "elect" to pay income tax and NICs on full market value at time of acquisition.		
				Income Tax and Class 1 National Insurance Contributions liabilities at acquisition a value of shares, but ignoring the right to convert. Further IT and NIC liabilities when conversion takes place, on difference in value between new shares acquired and shares given up.		
US						
- Non qualified stock options	Yes	Net fair market value	Exercise		Yes	
- Incentive stock options	No	Net fair market value	Disposal	Benefit treated as capital gains	No	
- Employee stock purchase plans	No	Net fair market value	Disposal	Benefit treated as capital gains	No	

Source: OECD (2005)

Based on the above table, it appears that in some foreign jurisdictions a deduction is allowed for companies in respect of its share based compensation expense. Furthermore, in some countries tax concessions are available to employees in respect of any benefit obtained through the acquisition of shares in return for services rendered.

It is not possible to analyse the taxation treatment of shares based compensation for all the countries listed above, however, for purposes of this document, the taxation treatment of share based compensation in the following countries will be explored in more detail:

- Australia

South Africa has in the past referred to the Australian tax system for guidance, i.e. the implementation of CGT in South Africa in 2001. Accordingly, a comparison of the South African tax legislation with the Australian tax legislation in respect of share based compensation should prove valuable.

Although it appears from the above table that no tax deduction is allowed to employer companies in respect of the issue of shares to employees in return for services rendered (i.e. taxation treatment similar to South Africa), special tax concessions seem to be available to employees in respect of the acquisition of the shares in return for services rendered.

- United Kingdom (“UK”)

Similar to the above, South Africa has in the past referred to the UK tax system for guidance, i.e. the implementation of CGT in South Africa in 2001. Accordingly, a comparison of the South African tax legislation with the UK tax legislation in respect of share based compensation should prove valuable.

Furthermore, the UK has various types of share incentive plans available which should provide a comprehensive overview of the taxation treatment thereof. It appears that, depending on the type of the plan, the tax consequences for the employer and employee differ. However, in many instances the company are entitled to a tax deduction in respect of the share based compensation whilst the employee is entitled to certain tax concessions. It would therefore be valuable to explore under which circumstances this tax relief would be available.

3.2 TAXATION TREATMENT OF SHARE BASED COMPENSATION IN AUSTRALIA

In Australia, the taxation treatment of share based compensation is found in Division 13A of Part III ITAA 1936 and sub-division 130A of the ITAA 1997 (the capital gains tax

provisions) (O'Connell, 2007:8). The general rule governing the taxation treatment of employee shares is that the issuing of shares or rights under an employee share scheme is taxable at the time the share or right is acquired (as opposed to when it vests) as it is treated as a substitute for cash income for services rendered. The amount to be included in the employee's assessable employment income is the difference between the market value of the share or right on the date of acquisition and any consideration provided, i.e. the amount of discount provided to the employee (O'Connell, 2007:8).

However, to the extent that certain requirements are met, Division 13A of the ITAA 1936 allows for two alternative concessions in respect of shares or rights acquired in return for services rendered.

The first concession, i.e. the exemption concession, allows for a discount of up to \$1 000 per income year. The second concession, i.e. the deferral concession, allows for tax on the discount provided to the employee to be deferred for up to 10 years.

Furthermore, in terms of Division 13A of ITAA 1936, the employer is also entitled to a deduction of \$1 000 per employee per income year, in respect of shares or rights issued under an employee share scheme where the exemption concession is satisfied. In the absence of the requirements of Division 13A of ITAA 1936, the issue of shares or rights by a company will not generally involve any cost to the employer and therefore no amount in respect of the share based compensation expense can be deducted for taxation purposes (O'Connell, 2007:14).

Below follows a more detailed discussion on the abovementioned legislation.

3.2.1 Division 13A of ITAA 1936

As indicated above, Division 13A of ITAA 1936 (which includes the provisions of section 139 of the ITAA 1936) provides for the taxation treatment of shares and rights acquired under employee share schemes. The key principle of this Division is that any discount from the market price of the shares or rights is assessable, i.e. should be included in the assessable income of the employee. However, two alternative concessions are available to employees in respect of the acquisition of shares or rights under schemes that satisfy

certain requirements, i.e. the exemption and deferral concessions. These concessions will be discussed in more detail later.

Section 139B(1) and (2) of the ITAA 1936 stipulates the following:

- “(1) If a taxpayer has acquired a share or right under an employee share scheme, the assessable income of the taxpayer includes the discount given in relation to the share or right.
- (2) Unless subsection (2A) or (3) applies, the discount is included in the taxpayer’s assessable income of the year of income in which the share or right is acquired.” (emphasis added)

Subsection (2A) refers to scenarios where a share or right was acquired by a taxpayer while not an employee whilst subsection (3) stipulates the following:

- “(3) If the share or right is a qualifying share or right and the taxpayer has not made an election under section 139E covering the share or right, the discount is included in the taxpayer’s assessable income of the year of income in which the cessation time (see section 139CA and 139CB) occurs.” (emphasis added)

From the above it is evident that the discount given in relation to the share or right would have to be included in the taxpayer’s assessable income in the year in which the share or right is acquired (in terms of section 139B(1) of 1936), unless the share or right is a “qualifying share or right” and an election under section 139E of the ITAA has not been made. If the share or right is a “qualifying share or right” and an election under section 139E has not been made, the discount would have to be included in the year of income in which the “cessation time” occurs (in terms of section 139B(3) of ITAA 1936). This would effectively result in the taxing event being deferred.

Section 139CD stipulates that a share in a company is a “qualifying share” if the following conditions are satisfied:

- The share or right is acquired by a taxpayer under an employee share scheme (“first condition”). (In this regard it should be noted that if the consideration payable for the

- The company is the employer of the taxpayer or a holding company of the employer of the taxpayer (“second condition”);
- All the shares available for acquisition under the scheme are ordinary shares and all the rights available for acquisition under the scheme are rights to acquire ordinary shares (“third condition”);
- At the time when the share was acquired, at least 75% of the permanent employees of the employer were, or at some earlier time had been, entitled to acquire:
 - shares or rights under the scheme; or
 - shares or rights in the employer, or a holding company of the employer, under another employee share scheme (“fourth condition”);
- Immediately after the acquisition of the share or right, the taxpayer does not hold a legal or beneficial interest in more than 5% of the shares in the company (“fifth condition”);
- Immediately after the acquisition of the share or right, the taxpayer is not in a position to cast, or control the casting of, more than 5% of the maximum number of votes that might be cast at a general meeting of the company (“sixth condition”).

Section 139CD stipulates that a right to acquire a share in a company is a “qualifying right” if the first, second, third, fifth and sixth condition (as per above) are satisfied.

If a qualifying share or right is acquired and the year of income in which the “cessation time” occurs is different from the year of income in which the share or right is acquired, section 139B(3) of ITAA 1936 will override section 139E(2) of ITAA 1936 unless an election is made under section 139E of ITAA 1936. In this regard, section 139E(1) stipulates that a taxpayer may make an election that section 139B(2) applies for a year of income, i.e. that the discount be included in the year in which the share or right is acquired as opposed to when cessation time occurs. The election covers each qualifying share or qualifying right acquired in that year by the taxpayer and must be made in the taxpayer’s return of income for the acquisition year. Section 139BA stipulates that if a taxpayer has made an election under section 139E for a year of income and the exemption conditions in

terms of section 139CE are satisfied in relation to shares or rights covered by the election, the discount is only included in the assessable income to the extent that it is greater than \$1 000 (“the exemption concession”). The effect of the election in terms of section 139E of the ITAA 1936 is thus that the discount is taxed upfront, however only to the extent that it exceed \$1 000.

Section 139CE sets out the exemption conditions that must be satisfied for the exemption concession to apply to a share or right acquired under an employee share scheme. The conditions are as follows:

- (1) the scheme did not have any conditions that could result in any recipient forfeiting ownership of shares or rights acquired under it (section 139CE(2));
- (2) the scheme was operated so that no recipient would be permitted to dispose of a share or right acquired under it, or of a share acquired as a result of a scheme right, before the earlier of the following times:
 - (a) the end of the period of 3 years after the time of the acquisition of the scheme share or right;
 - (b) the time when the taxpayer ceased, or first ceased, to be employed by the employer.
 - (c) Both the employee share scheme and any scheme for the provision of financial assistance in respect of acquisitions of shares or rights under the employee share scheme are operated on a non-discriminatory basis. Section 139 GF stipulates that a scheme is operated on a non-discriminatory basis if the following conditions are satisfied:
 - Participating in the scheme is open to at least 75% of permanent employees of the employer;
 - The time for acceptance of each offer is reasonable;
 - The essential features of each offer are the same for at least 75% of permanent employees of the employer.

To the extent that an election under section 139B(3) of ITAA 1936 was not made, and the share or right represents a qualifying share or rights, the discount will be included in the taxpayer's assessable income in the year of income in which the "cessation time" occurs. In terms of section 139(CA)(1), the "cessation time" for a share is the time when the taxpayer acquires the share if there is no restriction preventing the taxpayer from disposing of the share before a particular time and the scheme under which the share was acquired did not have any conditions that could result in the taxpayer forfeiting ownership of the share (i.e. where the share or right represents an unrestricted equity instrument upon acquisition).

If section 139(CA)(1) does not apply, i.e. the share is subject to certain restrictions on the date of acquisition, the "cessation time" for the share is the earliest of the following:

- the time when the taxpayer disposes of the share;
- the later of:
 - the time when any restriction preventing the taxpayer from disposing of the share ceases to have effect; and
 - the time when any condition that could result in the taxpayer forfeiting ownership of shares ceases to have effect;
- the time when the employment in respect of which the share was acquired ceases;
- the end of the 10 year period starting when the taxpayer acquired the share.

In terms of section 139CB the "cessation time" for a right is the earliest of the following:

- the time when the taxpayer disposes of the right (other than by exercising it);
- the time when the employment in respect of which the right was acquired ceases;
- if the right is exercised and there is a restriction preventing the taxpayer from disposing of the share acquired as a result of the exercise of the right or a condition that could result in the taxpayer forfeiting ownership of the share, the time when the last such restriction or condition ceases to have effect;
- if the right is exercised and there is no such restriction or condition, the time when the right is exercised;
- the end of the 10 year period starting when the taxpayer acquired the right.

The calculation of the discount to be included in the assessable income of the taxpayer is dealt with in section 139CC of the ITAA 1936. The rules for determining the amount to be included in assessable income vary according to whether the discount is assessable immediately or is deferred (O'Connell, 2007:11). Section 139CC stipulates that if the discount is covered by section 139B(2) or (2A) (i.e. discount is assessable immediately), the discount is the market value of the share or right at the time when it was acquired by the taxpayer less any consideration paid or given by the taxpayer as consideration for the acquisition of the share or right.

If the taxation of the discount is deferred in terms of section 139(3) of the ITAA 1936, and the share or right (or any share acquired as a result of the exercise of the right) was disposed of at arm's length within 30 days from the cessation time, the discount is calculated as the amount or value of any consideration received by the taxpayer for the disposal reduced by:

- the amount or value of any consideration paid or given by the taxpayer as consideration for the acquisition of the share or right; and
- for a right that has been exercised, the amount or value of any consideration paid or given to exercise the right.

If the taxation of the discount is deferred in terms of section 139(3) of the ITAA 1936, and the share or right (or any share acquired as a result of the exercise of the right) was disposed of at arm's length after 30 days from the cessation time, the discount is calculated as the market value of the share or right (or the share acquired as a result of the exercise of the right) at the cessation time reduced by the following:

- the amount of any consideration paid or given by the taxpayer as consideration for the acquisition of the share or right; and
- for a right that has been exercised, the amount of any consideration paid or given by the taxpayer to exercise the right.

From the employer's perspective, section 139DC(1) of the ITAA 1936 stipulates that a taxpayer is entitled to an allowable deduction in the taxpayer's assessment in respect of income of a year of income ("benefit year") if the taxpayer provides one or more qualifying

share or qualifying rights to another persons in the benefit year that satisfy the following conditions:

- the exemption conditions as per section 139(CE);
- the condition that no amount has been allowed, is allowable or will be allowable, as a deduction in the assessment of the taxpayer in respect of income of any year of income in respect of expenditure incurred in providing the share or right.

In terms of section 139(DC)(2), the amount of the deduction in respect of the shares or rights provided by the taxpayer to the person in the benefit year is the lesser of:

- \$1 000; and
- The sum of the market values, at the time that the share or right is provided, of each qualifying share or qualifying right that satisfies the conditions in section 139DC(1) reduced by the sum of any amounts paid by the person as consideration for those shares or rights.

Furthermore, only one deduction is allowable under section 139(DC) in respect of each person to whom the taxpayer provided shares or rights in a year.

3.2.2 Section 130 of ITAA 1997

The capital gains tax implications of a share or right acquired at a discount under an employee share scheme is dealt with in section 130-80 of ITAA 1997. Section 130-80(2) of ITAA 1997 stipulates that if the discount on shares or rights is subject to tax on acquisition, the cost base of the share or right will be market value at the time of the acquisition, i.e. the discount will be taxed under Division 13A of ITAA 1936 and the taxpayer will then be able to use the market value at the time of acquisition to determine the capital gain or loss (O Connell, 2007:16). In terms of section 130-83(2) of ITAA 1997, if tax is deferred and the share or right is disposed of within 30 days of cessation time, the capital gains tax provisions do not apply, i.e. the gain is included in assessable income. Furthermore, section 130-83(3) of ITAA 1997 stipulates that if tax is deferred and the share is disposed of more than 30 days after cessation time, the cost base of the shares is the market value at cessation time. This means that the difference between market value

of the share or right at cessation time and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A of ITAA 1936. Any subsequent increase in the value of the share or right will be subject to tax as a capital gain (O Connell, 2007:16).

In terms of section 102-5 of ITAA 1997, a taxpayer's assessable income includes any net capital gain for the income year. The net capital gain is any capital gain realised during the income year reduced with any capital losses realised during the current income year as well as any unapplied capital losses from previous income years. To the extent that the capital gain so calculated includes any "discount capital gain", the discount percentage, as envisaged by Division 115, is applied to the discount capital gains in order to arrive at the net capital gain to be included in the assessable income of the taxpayer.

In terms of Division 115 of ITAA 1997, a discount capital gain is a capital gain that meets the following requirements:

- The capital gain must be made by an individual, or a complying superannuation entity, or a trust or a life insurance company in certain instances (section 115-10);
- The capital gain must result from a CGT event happening after 11:45 am (by legal time in the Australian Capital Territory) on 21 September 1999 (section 115-15);
- The capital gain must have been worked out using a cost base that has been calculated without reference to indexation at any time or for a capital gain that arose under CGT event K7, using the cost of the depreciating asset concerned (section 115-20);
- The capital gain must result from a CGT event happening to a CGT asset that was acquired by the entity making the capital gain at least 12 months before the CGT event (section 115-25).

In terms of section 115-100, the discount percentage for purposes of a discount capital gain is:

- 50% if the gain is made by an individual or by a trust (other than a trust that is a complying superannuation entity or FHSA trust); or
- 33.3% if the gain is made by a complying superannuation entity or by an FHSA trust or by a life insurance company from a CGT asset that is a complying superannuation/FHSA asset.

3.2.3 Conclusion

From the above analysis of the Australian legislation in respect of share-based compensation it appears that limited relief is available to employees and employers in respect of share-based compensation in Australia as well. Similar to South Africa, relief only seems to be available in respect of employee share plans where the plan or scheme is open to the majority of employees, i.e. all employee share plans. However, it should be noted that, in terms of Australian tax legislation, any discount given by employers to employees in respect of shares or the right to acquire shares is included in the assessable income of the employee on acquisition date (as opposed to vesting date), unless the deferral concession applies (which would only be the case for employee share plans which are open for the majority of employees). This would mean that any growth in the discount subsequent to the acquisition date would be subject to CGT instead of normal tax. Being subject to taxation on acquisition date, as opposed to vesting date, is more beneficial to the employee as the employee is effectively exposed to taxation at a lower rate on any gains made subsequent to acquisition date.

3.3 TAXATION TREATMENT OF SHARE BASED COMPENSATION IN THE UK

The following share incentive schemes are implemented by companies in the UK:

- Standard, unapproved schemes;
- Approved Company Share Option Plans;
- Enterprise Management Incentives;
- Approved savings-related share option schemes;
- Approved Share Incentive Plans.

The above may be illustrated through the following table which show the number of companies operating the various tax-advantaged schemes in the UK (HMRC.....):

Table 3: Tax advantaged schemes implemented in the UK

Year	All-employee Schemes		Discretionary schemes	
	SAYE Share option schemes	Share incentive plans	Company/Discretionary share option plans	Enterprise Management Incentives
2000 – 01	1 110	90	4 270	870
2001 – 02	1 090	310	3 930	2 390
2002 – 03	920	490	3 660	3 540
2003 – 04	860	570	2 960	4 500

2004 – 05	820	750	2 710	5 660
2005 – 06	760	940	2 440	6 790
2006 – 07	780	940	2 450	8 020

Source: Adapted from HMRC Administrative database

Standard, unapproved schemes

Standard, unapproved schemes are standard company share option plans which have not been approved by HMRC and accordingly do not qualify for any specific tax relief. In terms of these schemes, employees would generally be granted a right (i.e. an option) to acquire shares from a future date at a fixed price. The fixed price is commonly the shares' value at the date the option is granted, the object being to provide a reward for the option holder based on future growth in share value. Any gain made on the exercise of the option is subject to income tax in the UK when the option is exercised. However, any gains enjoyed by employees may, provided certain requirements are met, be treated as an expense of the employer company for tax purposes (Postlethwaiteco).

Approved Company Share Option Plans (“CSOP”)

CSOP is a share option plan under which employees may be given a right (i.e. a share option), to buy a certain number of shares at a fixed price at a particular time (HMRC). If the scheme meets certain requirements, the scheme will be approved by the HMRC and certain tax advantages will be available to the employees in respect of the share options received, i.e. no income tax will be payable on any option gains realised by employees (Postlethwaiteco). Should the employees however dispose of the share subsequently; any gain on the disposal of the shares will be subject to CGT at a rate of 18% (Postlethwaiteco). CSOP is a discretionary scheme and therefore companies can choose which employees should participate in the scheme.

Once again, companies paying UK corporation tax may, provided certain requirements are met, claim as a statutory deduction against corporation tax the value of any benefit provided through the CSOP (Postlethwaiteco)

In order to qualify for the tax relief under CSOPs, certain requirements however need to be adhered to. These requirements are discussed in more detail later.

Enterprise Management Incentives (“EMI”)

EMIs are similar to CSOPs, however EMIs are aimed at smaller companies, i.e. companies with gross assets of no more than £30 million (Postlethwaiteco). It has been said that the tax relief under EMIs are the best of any UK share scheme and possibly the best in Europe (Postlethwaiteco).

In terms of an EMI, a company selects employees to participate in the scheme and grants options to buy shares in the company at a fixed price to these employees. To the extent that the option exercise price doesn't exceed the market value of the shares at the time of option grant, the employee would not be subject to income tax on any benefit received. If the shares are subsequently sold, CGT will become payable on any option gains, i.e. the difference between the exercise and sale price (Postlethwaiteco). Provided certain requirements are met, the employer company is also able to claim a deduction against corporation tax for the full amount of financial gain provided to the employees who exercised their options (Postlethwaiteco).

In order to qualify for the tax relief under EMIs, certain requirements need to be adhered to. These requirements are discussed in more detail later.

Savings related share option schemes (“SAYE”)

SAYE is an all-employee plan and therefore all employees must be invited to participate in the scheme. Effectively, the employer grants an option to an employee to acquire shares in the company at a fixed price at a fixed period in time. Each employee will only be granted the option if they agree to save a fixed amount per month for a minimum of three years in order to ensure that the total of their savings and interest will provide enough money for them to exercise their option. When the employee exercises its option to acquire shares after three years, no income tax is payable on any gain realised, i.e. the difference between the exercise price and the market value of the share. If the shares are subsequently sold, CGT will become payable on any option gains, i.e. the difference between the exercise and sale price (Postlethwaiteco).

For illustrative purposes, refer to the example below (Postlethwaiteco):

- A company wishes to offer each of its employees a share option. This allows them, after a fixed period of time has passed, to buy a fixed number of shares at today's share price (£1.25 per share) or at a discount of up to 20% on that price (£1 per share). The company decides to grant the option with a £1 exercise price;
- Each employee will only be granted the option if they agree to save a fixed amount per month for a minimum of three years, so that the total of their savings and interest will provide enough money for them to exercise their option;
- One employee, Justin, decides to save £100 per month for three years. After three years, this will give him £3 600 plus a tax free interest bonus of £240, total £3 840. He is granted an option to buy 3 840 shares.
- Three years later the share price has increased to £2.50. Justin uses his savings to exercise his option in full, paying £3 840 for shares which are now worth £9 600, so making a gain of £5 760.
- Normally Justin would have to pay income tax on this benefit, however, because the option is an approved SAYE option, he doesn't have to do so. However, when Justin sells the shares he will have to pay capital gains tax on any gain he has made up to the point of sales. However, it is much better to pay CGT than normal income tax.

Provided certain requirements are met, the employer company is also able to claim a deduction against corporation tax for the full amount of financial gain provided to the employees who exercised their options (Postlethwaiteco)

In order to qualify for the tax relief under SAYE, certain requirements however need to be met. These requirements are discussed in more detail later.

Approved share incentive plans ("SIP")

A SIP offers employees the opportunity to obtain shares in the employer company in three main ways:

- Purchase of "partnership shares" out of gross pay, with full income tax relief
- Employees may be allocated "free shares" without being required to pay income tax on their value;
- Employees may be allocated to two "matching shares" free for every one "partnership share", again without being required to pay income tax on their value.

Furthermore, dividends paid on any of the abovementioned shares may be paid as additional shares, i.e. “Dividend shares”, instead of cash. The receipt of the dividend shares are also not subject to tax.

The SIP must however be facilitated through a trust and therefore is excluded from the scope of this document.

The taxation treatment of share-related income and exemptions, as it pertains to the abovementioned share incentive plans or schemes are dealt with in Chapter 1 of Part 3 and Part 7 of ITEPA 2003. Refer below for a more detailed analysis of this legislation.

3.3.1 ITEPA 2003

The following sections in the ITEPA govern the taxation treatment of share-related income received by employees or directors by virtue of their employment:

- Chapter 1 of Part 3 (earnings) of the ITEPA;
- Part 7 of the ITEPA: Employment income: Share related income and exemptions. This Part contains special rules relating to directors or employees who acquire shares in companies or options relating to such shares, in connection with their office or employment. Part 7 of the ITEPA consists of chapter 2 to 11 and covers section 417 to 554 of the ITEPA.

3.3.1.1 Chapter 1 of Part 3 (earnings) of the ITEPA

In terms of Chapter 1 of Part 3 (earnings) of the ITEPA, earnings in relation to employment includes any gratuity or other profit or incidental benefit of any kind obtained by an employee if it is money or money’s worth or anything else that constitutes an emolument of the employment. In terms of this section, any shares awarded to employees in return for services rendered would constitute employment income and would thus be subject to taxation in the hands of the employee.

For example: An employee buys 2500 £1 shares in the company for £2000 at a time when the market value of the shares is £2500. There will be a charge to income tax under Chapter 1 of Part 3 (earnings) of ITEPA 2003 in respect of the difference between the market value of the shares, £2500, and the amount the employee pays, £2000.

Going forward, the capital gains cost is generally the market value of the shares at the date it was acquired (HMRC, 2009).

To the extent that the interest in the shares are however “only conditional”, chapter 2 of Part 7 of ITEPA contains specific provisions regarding the taxation treatment of the interest in the shares.

3.3.1.2 Part 7 of the ITEPA

Taxation treatment of interest in shares which are “only conditional” in the hands of employees

Chapter 2 of Part 7 of the ITEPA stipulates the taxation treatment of an interest in shares obtained by an employee which is “only conditional”. In terms of section 424 of ITEPA 2003, an interest in shares is “only conditional” for so long as the terms on which the person is entitled to it—

- (a) provide that if certain circumstances arise, or do not arise, there will be a transfer, reversion or forfeiture as a result of which that person will cease to be entitled to any beneficial interest in the shares, and
- (b) are not such that, on the transfer, reversion or forfeiture, that person will be entitled to receive in respect of the interest an amount that is equal to or more than its market value at that time.

Effectively, a beneficial interest in shares which is only conditional refers to shares which are restricted.

Section 427 of ITEPA 2003 stipulates that when the interest in the shares ceases to be only conditional, the taxable amount (to be determined in terms of section 428 of ITEPA 2003) should be included in the employment income of the employee. In terms of section 428 of ITEPA, the taxable amount for purposes of section 427 of the ITEPA should be calculated as the difference between the market value of the employee’s interest in the

share immediately after it ceased to be only conditional and any “deductible amount”. In terms of section 428(2) of ITEPA 2003, “deductible amount” includes any consideration given for the employee’s interest in the share and any amount that has been treated as employment income from the employee’s employment in terms of any other section of the ITEPA.

Taxation of share options in the hands of the employees (unapproved schemes)

Chapter 5 of Part 7 of the ITEPA deals with the general taxation treatment of share options in the hands of the employee and stipulates the following:

- no liability for income tax arises in respect of the receipt of a share option which has to be exercised before the tenth anniversary of the date on which it was obtained, except as provided for by section 526 (section 474(2), ITEPA 2003). Section 526 effectively provides that in instances where share options are granted at a discount in terms of an approved company share option plan (“CSOP”), the amount of the discount would be seen to constitute employment income of the individual for the relevant tax year. If the share option can be exercised after the tenth anniversary of the date on which it was obtained, the value that should be taken into account for purposes of any liability to tax by virtue of Chapter 1 of Part 3 (earnings) is the difference between MV and C (section 475, ITEPA 2003).

“MV” being the higher of

- the market value at the time the share option is obtained of the shares that are the subject of the share option, and
- the market value at that time of any shares for which those shares may be exchanged, and

“C” being

- the amount or value of the consideration for which the shares that are the subject of the share option may be acquired, or
- if that consideration is variable, the least amount or value of the consideration for which they may be acquired.

- To the extent that the share option is exercised, assigned or released by an employee, section 476 stipulates that the taxable amount as determined under section 478 should be regarded as employment income of the employee for the relevant year. Section 476 is however subject to section 519, 524 and 530 which deals with the taxation treatment of share options acquired in terms of SAYE, CSOP and EMI schemes (refer below for the taxation treatment of the exercise of share options acquired under these schemes).

In terms of section 478, the taxable amount is calculated as the difference between the “amount of the gain” and the total of any “deductible amounts”. Depending on whether the share option was exercised or assigned or released, the “amount of the gain” is calculated in terms of the provisions of section 479 and 480. Section 478(2) stipulates what amounts would qualify as “deductible amounts”. Effectively, any amount that constitutes earnings from the employee’s employment under Chapter 1 of Part 3 (earnings) would, inter alia, qualify as a deductible amount (i.e. arguably to avoid double taxation).

Section 479 stipulates that the “amount of the gain” realised by exercising the share option is the difference between the amount that a person might reasonably expect to obtain from a sale of the shares acquired in the open market at the time the option is exercised (i.e. the market value of the shares) and the total of any deductible costs. Section 479 (2) stipulates that the amount or value of any consideration given for the grant of the share option as well as the amount or value of any consideration given for the shares acquired would, inter alia, constitute deductible costs.

Section 480 stipulates that the “amount of the gain” realised by assigning or releasing the option is the difference between the amount or value of the consideration for the assignment or release and the total of any deductible costs. Section 480(2) stipulates that the amount or value of any consideration given for the grant of the share option would, inter alia, constitute a deductible cost.

Going forward, the cost of the shares for CGT purposes is the total of the following:

- The price paid for the option (if anything);

- The price paid for the shares when the option was exercised;
- The amount chargeable to income tax on the exercise (HMRC, 2009)

Taxation of share options in the hands of the employees (approved schemes)

Chapters 7, 8 and 9 of Part 7 of the ITEPA deals with the taxation of share options in the hands of the employee in terms of approved SAYE option schemes (chapter 7), approved CSOP schemes (chapter 8) and EMI (chapter 9).

The taxation treatment of share options in the hands of employees in terms of an approved SAYE option scheme is discussed first.

SAYE option scheme

In order for a SAYE option scheme to be approved by HMRC, the requirements of Schedule 3 of ITEPA 2003 should be met. These requirements include, inter alia, that the scheme must be an all-employee scheme, only options in respect of ordinary shares may be granted to employees and the shares must be in a company not controlled by another (unless listed).

To the extent that the SAYE option scheme is approved by the HMRC, the taxation treatment of the share option in the hands of the employee is as follow:

- No liability to income tax arises in respect of the receipt of the share option (section 518, ITEAPA 2003);
- No liability to income tax arises in respect of the exercise of the share option, if the individual exercises it in accordance with the provisions of the SAYE option scheme at a time when the scheme is approved and the option is exercised on or after the third anniversary of the date on which it was granted. If the option is exercised before the third anniversary of the date on which it was granted and is so exercised otherwise than by virtue of a provision included in the scheme under paragraph 34(5) of Schedule 3 (exercise of option where scheme-related employment ends), or paragraph 37 of that Schedule (exercise of option where certain company events occur), it would still not be subject to income tax.

Should the employee sell the shares subsequently, any gain realised on the disposal would be subject to CGT at 18% (and not normal income tax) (Postlethwaiteco). The capital gains cost of the shares is usually what you pay for them when you exercise your option (HMRC, 2009). The proceeds would be the amount received by the employee in respect of the disposal of the shares. The difference between the proceeds and the capital gains cost of the shares would constitute the gain which would be subject to CGT.

CSOP

In order for a CSOP scheme to be approved by HMRC, the requirements in terms of Schedule 4 should be met. These requirements include, inter alia, that an employee may not be granted share options in terms of the scheme which would exceed £30 000, the shares in terms of which the options are granted must constitute ordinary shares and the shares must be in a company not controlled by another (unless listed).

To the extent that the CSOP scheme is approved by the HMRC, the taxation treatment of the share option in the hands of the employee is as follow:

- No liability to income tax arises in respect of the receipt of the share option (section 523, ITEAPA 2003). However, this is subject to section 526 which stipulates that if an option is granted at a discount, the amount of the discount should be included in the employment income of the employee in the year in which the option is granted to the employee. An option would be deemed to be granted at a discount if, at the time when the share option is granted to the employee, the aggregate of
 - the amount or value of any consideration given by the employee for the grant of the option; and
 - the amount payable by the individual, on exercising the option, in order to acquire the maximum number of shares that may be acquired under it,is less than the market value of the same quantity of issued shares of the same class.
- No liability to income tax arises in respect of the exercise of the share option if the employee exercises it in accordance with the provisions of the CSOP scheme at a time when the scheme is approved and the option is exercised on or after the third anniversary of the date on which it was granted but not later than the tenth anniversary

of that date and the individual has not made an exempt exercise of another option within the period of 3 years ending with the date on which the current option is exercised (section 524, ITEAPA 2003).

For purposes of the above, an employee would be deemed to have made an exempt exercise of another option if the employee has exercised a share option granted under the scheme, or under any other approved CSOP scheme, and where the exercise of the share option was exempt from income tax in terms of section 524 and an option exercised on the same date as the current option is to be disregarded.

Should the employee sell the shares subsequently, any gain realised on the disposal would be subject to CGT at 18% (and not normal income tax) (Postlethwaiteco). The capital gains cost of the shares is usually what you pay for them when you exercise your option (HMRC, 2009). The proceeds would be the amount received by the employee in respect of the disposal of the shares. The difference between the proceeds and the capital gains cost of the shares would constitute the gain which would be subject to CGT (HMRC).

EMI

Chapter 9 of Part 7 of the ITEAPA provides for the taxation treatment of qualifying options in terms of EMIs. Schedule 5 contains the requirements that have to be met for a share option to be a qualifying option. The requirements in terms of Schedule 5 includes, inter alia, that an employee may not hold unexercised qualifying options with a total value of more than £120 000 (for grants made after 5 April 2008), the total value of shares in the relevant company in respect of which unexercised qualifying options exist must not exceed £3 million and the company must not have gross assets of more than £30 million.

To the extent that a share option constitutes a qualifying option for purposes of the EMI, the taxation treatment of the share option in the hands of the employee is as follow:

- No liability to income tax arises in respect of the receipt of the share option (section 528, ITEAPA 2003);

- No liability to income tax arises in respect of the exercise of the share option, if the option is exercised within ten years and if the option is to acquire shares at not less than their market value at the time when the option is granted.

Should the employee sell the shares subsequently, any gain realised on the disposal would be subject to CGT at 18% (and not normal income tax) (Postlethwaiteco). The capital gains cost of the shares is usually what you pay for them together with the amount charged to income tax (if any) when you exercise your option (HMRC,2009). The proceeds would be the amount received by the employee in respect of the disposal of the shares. The difference between the proceeds and the capital gains cost of the shares would constitute the gain which would be subject to CGT.

Taxation of share options in the hands of the employers

Schedule 23 of the Finance Act 2003 stipulates the corporation tax relief for an employer in respect of an employee share acquisition. In general, Schedule 23 of the Finance Act 2003 provides for corporation tax relief for a company where a person –

- (a) acquired shares by reason of his, or another person's, employment with that company (an "award of shares"); or
- (b) obtains by reason of his, or another person's, employment with that company an option to acquire shares and acquires shares in exercise of that option (a "grant of an option").

Relief under Schedule 23 is however only available if the requirements of Schedule 23 are met as to-

- (a) the business for the purposes of which the award or grant is made (paragraph 3);
- (b) the kind of shares acquired (paragraph 4);
- (c) the company whose shares are acquired (paragraph 6 and 12); and
- (d) the income tax position of the employee (paragraph 7, 14 or 20).

The business for the purposes of which the award or grant is made

In terms of paragraph 3, the business for the purposes of which the award or grant is made must –

- (a) be carried on by the employing company, and
- (b) be within the charge to corporation tax.

In terms of section 3(2), a business is within the charge to corporation tax if, or to the extent that, it is carried on by a company that is within the charge to corporation tax in respect of the profits of the business.

The kind of shares acquired

In terms of paragraph 4, the shares acquired must meet the following requirements:

- they must be ordinary shares that are fully paid-up and not redeemable;
- they must be
 - shares of a class listed on a recognised stock exchange, or
 - shares in a company that is not under the control of another company, or
 - shares in a company that is under the control of a company (other than a close company or a company that if resident in the United Kingdom would be a close company) whose shares are listed on a recognised stock exchange.

The company whose shares are acquired

In terms of paragraph 6, where an award of shares are made, the shares acquired must be shares in –

- (a) the employing company; or
- (b) a company that, at the time of the award, is a parent company in relation to the employing company; or
- (c) a company that, at the time of the award, is a member of a consortium that owns the employing company or a company within paragraph (b); or
- (d) where at the time of the award the employing company or a company within paragraph (b) is a member of a consortium that owns another company, a company (C) that at that time-
 - (i) is a member of the consortium or a parent company in relation to a member of the consortium, and
 - (ii) is also a member of the same commercial association of companies as C.

In terms of paragraph 12, the company whose shares are acquired in exercise of the option must be –

- (a) the employing company; or

- (b) a company that, at the time of the aware, is a parent company in relation to the employing company; or
- (c) a company that, at the time of the aware, is a member of a consortium that owns the employing company or a company within paragraph (b); or
- (d) where at the time of the aware the employing company or a company within paragraph (b) is a member of a consortium that owns another company, a company (C) that at that time-
 - (i) is a member of the consortium or a parent company in relation to a member of the consortium, and
 - (ii) is also a member of the same commercial association of companies as C.
- (e) a qualifying successor company.

The income tax position of the employee

In terms of paragraph 7, where an award of shares were made, it must be the case that the employee is subject to a charge to income tax under ITEPA 2003 in respect of the award or would be subject to such a charge if the conditions specified in paragraph 7(2) were met. The conditions in paragraph 7(2) are the following:

- (a) that the employee was resident and ordinarily resident in the United Kingdom at all material times, and
- (b) that the duties of the employment by reason of which the award was made were performed in the United Kingdom at all material times.

In terms of paragraph 14(1), where an option was granted to an employee, it must be the case that the employee-

- (a) either -
 - (i) was subject to a charge to income tax under the ITEPA 2003 in respect of the grant of the option, or
 - (ii) is subject to a charge to income tax under that Act by virtue of section 476 or 477 of that Act in respect of the gain realised by the exercise of the option, or
- (b) would be subject to such a charge as is mentioned in paragraph (a)(ii) but for a relevant exemption, or
- (c) would be within paragraph (a) or (b) of the conditions specified section 14(3) were met.

For purposes of section 14(1)(b), a “relevant exemption” means an exemption under

- (a) section 519, 520, 524 or 525 of the ITEAPA 2003 (exercise of option under approved SAYE scheme or approved CSOP scheme), or
- (b) section 530 of that Act (exercise of qualifying option under EMI code).

The conditions contained in section 14(3) are the following:

- (a) that the employee was resident and ordinarily resident in the United Kingdom at all material times, and
- (b) that the duties of the employment by reason of which the option was granted were performed in the United Kingdom at all material times.

To the extent that the abovementioned requirements in respect of the business for the purposes of which the award or grant is made, the kind of shares acquired, the company whose shares are acquired and the income tax position of the employee are met, the employer would be entitled to corporate tax relief.

In terms of paragraph 8(1), the amount of the relief in respect of an award of shares is equal to the difference between –

- (a) the market value of the shares at the time of the award; and
- (b) the total amount or value of any consideration given, by the recipient or another, in respect of the shares.

The amount of the relief is allowed as a deduction in computing for the purposes of corporation tax the profits of the business for the purposes of which the award was made (paragraph 9(1), Finance Act 2003). The relief is given for the accounting period in which the recipient acquires the shares (paragraph 10(1), Finance Act 2003).

In terms of paragraph 15(1), the amount of the relief in respect of the grant of an option is equal to the difference between –

- (c) the market value of the shares at the time the option is exercised; and
- (d) the total amount or value of any consideration given, by the recipient or another, in respect of the grant or exercise of the option.

The amount of the relief is allowed as a deduction in computing for the purposes of corporation tax the profits of the business for the purposes of which the award was made

(paragraph 16(1), Finance Act 2003). The relief is given for the accounting period in which the shares are acquired in exercise of the option (paragraph 17(1), Finance Act 2003).

In the case where an award of shares or where the acquisition in exercise of an option of shares is subject to forfeiture, special provisions in terms of Part 4 apply regarding the relief available to the employer. Effectively, the relief is given for the accounting period in which the shares cease to be subject to forfeiture (section 22(2), Finance Act 2003). Furthermore, the amount of relief is calculated with reference to the market value of the shares at the time at which the shares cease to be subject to forfeiture (section 21(3), Finance Act 2003).

3.3.2 Conclusion

From the above it is evident that any shares or share options acquired by virtue of employment would attract normal income tax in the UK, unless the particular scheme is a share option scheme approved by the HMRC which provides for specific tax relief on the receipt and exercise of the share option, i.e. SAYE, CSOP and EMI schemes. In the absence of any tax relief, the taxing event for share options is on the date when the share option is exercised (as opposed to acquisition or vesting date). The taxation event in respect of the award of shares is either on acquisition date or on the date the interest in the shares ceases to be only conditional.

In order to qualify for the tax relief in terms of SAYE, CSOP and EMI schemes, strict requirements need to be adhered to. In order to qualify as a SAYE scheme, the scheme, inter alia, needs to be an all employee scheme. In order to qualify as a CSOP or EMI scheme, certain financial limitations, inter alia, needs to be adhered to. However, to the extent that these requirements are met, employees are generally only subject to CGT at 18% on any gains realised as a result of the eventual disposal of shares acquired as a result of share options granted to them by virtue of employment. Normal income tax is not payable on any gains so realised which results in a substantial tax saving to the employee.

Furthermore, to the extent that certain requirements are met, employers are also entitled to a corporate tax deduction equal to the difference between the market value of the shares on the date of the award or the market value of the shares on the date on which the

option is exercised and any consideration given by the employee in respect of the award of the shares or the grant or the exercise of the option. This relief could be available to the employer even to the extent that the share incentive scheme constitutes a SAYE, CSOP or EMI scheme.

CHAPTER 4

CONCLUSION

The research question that drove this study was whether or not the current taxation treatment of share-based compensation in South Africa, from both an employer and employee perspective, is in line with practices followed internationally. For purposes of this research question, a review was performed of local as well as international tax legislation on the matter. The international tax legislation reviewed focused on the legislation in Australia and the UK.

From the review of the Australian and UK legislation, it appears that the legislation in South Africa governing share-based compensation in the hands of employers and employees are more restrictive than legislation applied internationally. For example, in South Africa, any gain made as a result of the vesting of an equity instrument acquired by virtue of employment is included in the taxable income of the employee. No concessions are available to the employee in respect of the gain so realised unless the share is obtained in terms of a broad based employee share plan. If obtained in terms of a broad based employee share plan, the taxing event will be deferred to the date of disposal of the shares (as opposed to vesting date), however, the gain would still be subject to normal income tax (and not CGT). Only certain share incentive plans will however qualify as broad based employee share plans and accordingly this relief would only be available in limited situations. To the extent that the relief is however available, a deduction in respect of the issue of the shares would also be available to the employer, however the deduction would be limited to a maximum of R10 000 per employee per year. Other than the relief provided in terms of the broad based employee share plans, no other relief is available to employees and employers in respect of the share incentive plans which formed the basis of this study.

Although the relief available in Australia in respect of share incentive plans (from both an employer and employee perspective) also appears to only relate to share incentive plans of an all-employee nature (i.e. the exemption and deferral concessions), it is submitted that employees are generally subject to normal income tax on the date of acquisition of the share or share option, as opposed to the date on which the share or share option vests.

Any growth in the value of the share or share option subsequent to the acquisition date is thus subject to CGT as opposed to normal income tax. As indicated previously, being subject to taxation on acquisition date, as opposed to vesting date (which is the case in South Africa), is more beneficial to the employee as the employee is effectively exposed to taxation at a lower rate on any gains made subsequent to acquisition date.

The UK however seems to have the most favourable tax legislation in respect of share based compensation. In some ways, the legislation in the UK appears to be similar to the legislation in South Africa, i.e any benefit obtained as a result of an award of shares is subject to normal income tax on acquisition date unless the interest in the shares are restricted (only conditional). Only when the restrictions lift, i.e. when the share vests in the employee, would the employee be subject to normal income tax on the benefit received.

However, in respect of share options granted to employees under an unapproved scheme, it should be noted that the employees are only subject to taxation on any benefit received on the date that the share options are exercised (as opposed to vesting date which is the case in South Africa). Although not necessarily a tax benefit, the benefit of only be subject to tax on exercise date (as opposed to vesting date) is that the employee should be able to sell some of the shares acquired as a result of the exercise of its options in order to settle the income tax liability that becomes due on exercise date. To the extent that an employee becomes subject to taxation on vesting date of a share option, the employee may not yet have exercised its option to acquire shares and therefore may find it difficult to settle any tax liability that arise from the vesting of the share option as it is not in a position to sell any of the underlying shares in order to fund the tax liability.

The most beneficial part of the UK legislation (from an employees perspective) is however the relief provided in terms of share incentive plans approved by HMRC. To the extent that an employee receives share options in terms of an approved share incentive plan, i.e. SAYE, CSOP and EMI schemes, the employee would effectively only be subject to CGT at 18% on the eventual disposal of the shares acquired by virtue of the share options issued to them. No income tax would be payable on any gain realised in respect of the share options. Strict requirements need to be adhered to in order for a share incentive plan to be approved by the HMRC. Therefore it is submitted that not all corporate entities would want to implement these types of schemes as it may not cater for all companies' needs.

However, at least companies have the choice of implementing one of these tax advantage schemes should it meet the requirements, an option South African companies does not have.

From the employers' perspective, the UK also seems to have the most beneficial tax legislation. Provided certain requirements are met, employers' are effectively entitled to a deduction in respect of any gain realised by employees in respect of the issue of shares or the right to acquire shares in the company.

Based on the above it is thus evident that although tax legislation governing share-based compensation in South Africa are in some ways in line with practices implemented internationally, for most parts it still appears to be far more restrictive than legislation internationally.

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