South African
Institute of
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Dear Ms. Mputa and Mr. Tomasek

RE: FURTHER REFINEMENTS TO SECTION 8C (AND SECTION 8B) OF THE INCOME TAX ACT

The SAIT Corporate Tax Committee ("Committee") would like to thank you for your open and transparent approach throughout the legislative process. Based on Annexure C of the Budget, we know that share schemes are again an item of concern.

In the submission that follows, we are making several recommendations to ensure that share schemes (many of which are broad-based as intended within Government transformation policies) are not subject to inadvertent double taxation or are taxed at a technical gain that exceeds economic gain. On the other side of the equation, we also agree with the concern that certain management share schemes continue to exist in the market that are undermining the intention of section 8C through the use of payments technically qualifying as "exempt" dividends. This submission accordingly contains legislative recommendations in this regard. Lastly, the Committee wishes to draw your attention to problems experienced with section 8B (a broad-based share incentive provision that has been shown to be of little utility in the market).

We trust that this submission will assist you in the drafting process.

Should you have any further questions, please do not hesitate to contact me.

Yours sincerely,

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Chairman: SAIT Corporate Tax Committee

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PRACTICAL PROBLEMS EXPERIENCED WITH SECTION 8C

1 Possible restrictions due to pre-emptive rights attaching to an equity share

Problem statement

Questions frequently arise as to whether pre-emptive rights of certain shareholders (e.g. BEE shareholders) would cause an equity instrument to be classified as a "restricted equity instrument" (in terms of paragraph (a) of the definition in section 8B(7)). In a situation of this kind, employees are often subject to pre-emptive rights to their co-shareholders before sale (a "right of first refusal"). In a closely held situation, the employee must provide co-shareholders with a fair market value right of purchase (or provide a company with a buy-back right). In the BEE space, fellow BEE shareholders receive a similar right of first refusal.

At issue is whether this right of first refusal is viewed as preventing the employee from "freely disposing of the equity share" (as envisaged in paragraph (a) of the definition of "restricted equity share" in section 8B(7)) even though the price must be at fair market value? Currently, different views are expressed as to whether this would constitute a restriction with the most popular view being that it depends on the time that the holder of the pre-emptive right has to exercise that right.

In raising this issue, one must also consider the fact that the standard pre-emptive right temporarily freezes the value at a price that may differ from the value on the actual disposal date. Consider the following example:

> An employee wants to dispose of an equity share to the listed market, but a manager within the company has a pre-emptive right in respect of the equity share. In terms of the right, the manager must buy the share at market value (which we assume is R100 on the date of offer by the employee) and has 30 days from the date the share is offered to exercise his right. We further assume that in addition to the manager's pre-emptive right, another shareholder also has a pre-emptive right to acquire the share at its market value of R100 but that this pre-emptive right is secondary to the right of the manager and may only be enforced if the manager didn't enforce his right within the 30 days. In this case, should the shareholder exercise his pre-emptive right to acquire the share at R100, the market value of the share may have increased to R120.

In the above example, the equity share is disposed of at a price based on the initial time set by the initial employee offer. However, the right effectively freezes the price from increasing to R120 – the date of actual disposal. This deviation should presumably be ignored because the price is only matching the initial independent purchase offer (i.e. is similar to any purchase contract with the price

being set on the initial agreement date as opposed to the actual date of physical transfer and payment).

Proposed solution/recommendation

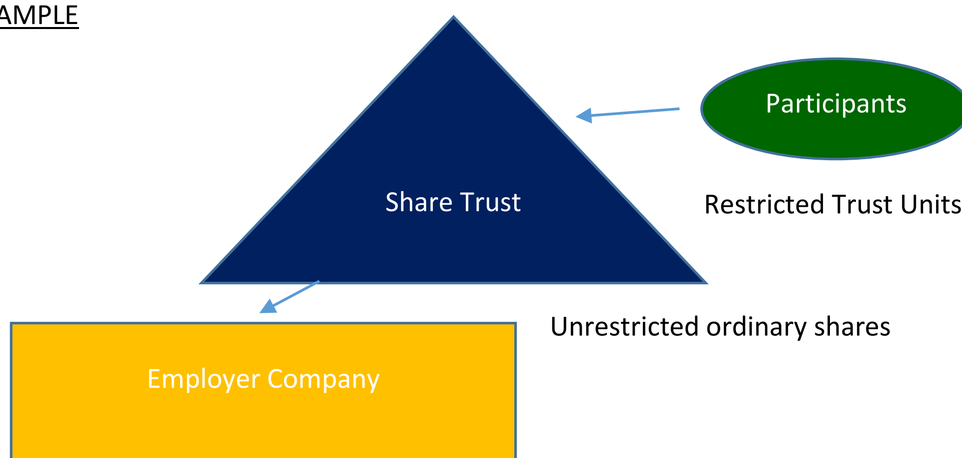
Pre-emptive rights of first refusal should not trigger "restricted equity instrument" treatment as long as the price matches the independent offer. Subsequent price deviations outside the control of the parties involved should not be viewed as an improper restriction because a freeze against these deviations are not indicative of a closed set of shares (but a standard rule of convenience). In addition, some notice period of 60/90 days should be allowed so that the parties holding pre-emptive rights can determine if sufficient financing is available.

2 The interaction between section 8C of the Act and paragraph 80 of the Eighth Schedule to the Act

Employee share trusts are the most widely used format for offering shares to rank-and-file employees on an ongoing basis. The trust format is also widely used for black economic empowerment schemes designed for multiple beneficiaries. The trust format provides for administrative flexibility and central administrative control over the underlying shares.

Our main concerns relates to possible double taxation, especially where shares are not vested in particular employees upon the share entry into the trust. Vesting can only occur where all employees to a scheme are known upfront. Most schemes are open for new employees so complete vesting is generally not possible, especially when schemes are being designed for a large number of shareholders. Upfront vesting is only practically feasible in the case of smaller plans (where the risk of avoidance by a small group of colluding executives is highest). The request below is simply aimed at reducing double taxation.

EXAMPLE



i. Trust formation

- A South African employer company forms an employee share incentive trust to incentivise qualifying employees of the employer company. The employees participate in the scheme through trust units whose value is linked to the employer company shares held by the trust.
- The trust units issued to the participants are restricted equity instruments (see paragraph (c) of the definition of "equity instrument" in section 8C(7)). These trust units are issued to the participants as a group when the scheme starts and further units are issued as employees join the company and with the annual passage of time. These units are issued for no consideration (other than the satisfaction of employee conditions.
- The underlying employer company shares acquired by the Trust carry no restrictions as contemplated in section 8C and are acquired by the trust at a cost of say R100 per share.

ii. Options for share exit

- Option 1: At the end of 5 years, the Trust disposes of the shares in the market (or back to the company) for R120 and distributes the proceeds to the Participants. The contractual right of the Participants vis-à-vis the Trust is extinguished by the distribution.

- Option 2: At the end of 5 years, the Trust distributes the shares (with a market value of say R120) to the Participants. The contractual right of the Participants vis-à-vis the Trust is extinguished by the distribution.

iii. Current tax implications (Option 1)

- The proceeds on disposal of the shares by the Trust would be capital in nature in terms of section 9C of the Income Tax Act. The disposal will trigger a capital gain of R20 which can be attributed to the Participants under paragraph 80(2).
- The distribution by the Trust to the Participants will trigger a vesting of the Trust Units and will trigger a section 8C gain of R120.
- As a result of the attribution by paragraph 80 of the "capital gain" the Participants will technically be subject to CGT on the R20 capital gain in addition to the R120 section 8C gain.

  Note: SARS issued Binding Private Ruling 174 on 29 July 2014 wherein the Trust was found to have a base cost of R120 for the shares in terms of paragraph 20(1)(h)(i) of the Eighth Schedule to the Income Tax Act. The relevant subparagraph provides that the base cost of a marketable security or equity instrument, the acquisition or vesting of which resulted in the determination of any gain or loss to be included or deducted from any person's income in terms of section 8C, will be the market value of the instrument or amount received/accrued from the disposal thereof, that was taken into account in determining the 8C gain. In the example above, it is the vesting of the Trust Units rather than the Employer Company shares which triggers the section 8C gain. Paragraph 20(1)(h)(i) is therefore not applicable. In any

event the application of paragraph 20(1)(h)(i) to provide a base cost in the hands of a person other than the person subject to the section 8C gain seems technically questionable.

iv. Current tax implications (Option 2)

- The vesting of the asset in the Participants would trigger a disposal in terms of paragraph 11(1)(d) of the Eighth Schedule. The disposal would be deemed to take place at market value in terms of paragraph 38 (read with the definition of "connected person" in section 1). The proceeds on disposal of the shares by the Trust would be capital in nature in terms of section 9C. The disposal will trigger a capital gain of R20, which can be attributed to the Participants under paragraph 80(1) of the Eighth Schedule to the Income Tax Act.
- The distribution by the Trust to the Participants will trigger a vesting of the Shares and / or Trust Units, thereby triggering section 8C gain of R120.
- As a result of the attribution by paragraph 80 of the "capital gain", the Participants will technically become subject to CGT on the R20 capital gain in addition to the R120 section 8C gain.

v. Recommendation

General comments

The provisions of paragraph 20(3) and 35(3) of the Eighth Schedule to the Income Tax Act generally ensure that amounts which have already been included in the determination of normal tax are excluded from the base cost and proceeds when determining a person's capital gain or loss. However, the problem at hand exists because these schemes have two levels of ownership (i.e. of two different assets) – participant ownership of trust units and trust ownership of employer company shares.

If shares are sold before cash is distributed, paragraph 80(2) attributes only the Trust's capital gain to the beneficiary's aggregate capital gain or aggregate capital loss rather than the capital gain's constituent parts (i.e. both its base cost and proceeds). As currently drafted, it is not possible to rely on paragraph 35(3) to exclude the amount received on the disposal of the shares from the proceeds (paragraph 80(1) of the 8th Schedule).

Possible alternatives

Setting aside all of the technical niceties, the end goal is to ensure that the beneficiaries are subject to one level of tax at ordinary rates. Stated differently, this fix contains two elements – taxation at ordinary rates for the share gains and elimination of the inadvertent second tax charge on the same gains. We would accordingly suggest the following:

1) Shares sold within an employee share trust for the benefit of the employees should be subject to tax at ordinary rates. One can create this deeming charge if one or more trust beneficiaries are

subject to section 8C, the shares are part of an employee trust scheme under section 95 of the Companies Act or the shares are part of a trust intended for enjoyment by one or more employee beneficiaries.

2) Under the second rule, any section 8C gain in respect of a trust instrument should be reduced to the extent that the gain stems from section 8C shares already subject to tax.

VI Note on Paragraphs 11(2)(j) and 80 of the Eighth Schedule

- In terms of paragraph 11(2)(j), there is no disposal of an equity instrument contemplated in section 8C which has not yet vested as contemplated in that section. If the dual ordinary approach is adopted above, paragraph 11(2)(j) should instead be extended to cover the actual conversion to vesting itself.
- Alternatively, paragraph 80 needs to be tested to ensure that amounts subject to section 8C are not taxed again under paragraphs 80(1) or 80(2).

3 Interest incurred on company loans to employees

Problem statement

With share schemes, it became common practice for companies to provide the employee with a loan from day one to acquire the equity shares. These loans normally bear interest and would typically remain outstanding until the vesting of the equity instrument (which must be repaid together with interest incurred by the employee). This interest is therefore effectively increasing the exercise price for the employee to acquire the share.

In BPR 074 of 29 January 2013, SARS expressed the view that SARS would not allow this interest to form part of the "consideration" as defined in section 8C(7). This refusal has the effect that the interest would not reduce the gain (or increase the loss) in terms of section 8C(2) upon the vesting of the equity instrument. The logic behind the ruling was that the interest is incurred in order to acquire shares and are therefore not deductible. However, section 8C shares are not like normal shares. These shares generate ordinary revenue so the interest incurred by the employee was a real "cost" reducing net profit (similar to an interest charge against trading stock).

Proposed solution/recommendation

It is proposed that the interest incurred on in respect of employee share loans to acquire section 8C instruments act as a full offset against the section 8C gain (i.e. be treated as "consideration" as defined in section 8C(7) of the Act).

4 Closure of Avoidance Schemes

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National Treasury and SARS rightly identified a narrow set of shares schemes that continue to remain in the market despite the previous anti-avoidance legislation to the contrary. Many of these schemes previously involved preference shares, but preference shares can be problematic for taxpayers for various reasons (e.g. not being section 9C equity shares). Under newer formulations, pure equity shares within an ordinary class can be separately held via an independent management controlled vehicle (e.g. a management shell company).

We believe that these schemes need to be closed as outside the primary intention of section 8C. As long as these schemes continue to exist in the market, we suspect that further anti-avoidance legislation will follow. The history of this anti-avoidance issue has unfortunately been the cause of uncertainty for legitimate grass-roots schemes, meanwhile the intended schemes of elite managers go unchallenged.

The schemes of concern come in two forms. The underlying shares can be repurchased by the operating company (or a special purpose company) with the repurchase being treated as a technical dividend (because buy-backs generally qualify as dividends). Another variation is self-liquidation shares with dividends that are so large as to leave no value on the corpus. In essence, the escape route to section 8C are payments qualifying as technical dividends.

In order to counter these schemes, we would recommend the following:

- The buy-back of shares qualifying as restricted shares (or of shares within a trust scheme subject to section 8C) should not be treated as dividends. These buybacks should be treated as a disposal event (or as dividends not eligible for the section 10(1)(k)(i) exemption or simply as a section 8C gain).

- Shares that produce excessive dividends should similarly targeted with a mechanism similar to paragraph 19 of the Eighth Schedule. Under this approach, dividends in excess of 15 per cent of the corpus should be treated as fully taxable dividends (i.e. lose the benefit of the section 10(1)(k)(i) exemption).

The above anti-avoidance measures should finally close the share incentive schemes of elite management without disrupting broad-based schemes (which often involve recurring dividends falling under 5 per cent of total value).

PRACTICAL PROBLEMS EXPERIENCED WITH SECTION 8B

1 Low uptake of section 8B

Problem statement: Employee technical involvement in multiple schemes

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It is widely recognised that the uptake of section 8B is very low. We believe that fewer than 10 companies within South Africa have utilised section 8B. As far as we understand, no company has newly entered the programme for the last few years.

One factor that may contribute towards this weak uptake may stem from the requirement within the definition of "broad-based employee share plan" (paragraph (b) of section 8B(3)). This paragraph disqualifies employees from participating in the broad-based employee share plan if the beneficiary is already participating in another equity scheme of the employer company (or an associated institution). While this requirement seems innocuous, this situation often arises when employees switch companies within a group. Employees can also find themselves in this situation if an employer company is in the process of winding down one existing share scheme as a new share scheme is being started.

Proposed solution/recommendation

It is submitted that share ownership in multiple companies be allowed or that some form of *de minimis* threshold be provided. One can utilise a 5 per cent threshold (see section 12(4) - (paragraph (b) of the "small business corporation" definition) or even a 1 per cent threshold. Another alternative may be to drop the 5-year aggregate test and limit the test to a test that applies solely per annum.

2 Date of grant for shares issued in tranches

Problem statement

Uncertainty exists as to exactly when shares issued at different times to different employees (all forming part of the same share scheme) must be valued for purposes of the definition of "qualifying equity share" (when read with the "date of grant" definition in section 8B(3)). This technical issue raises a practical problem because employers typically want to provide open schemes with new shares issued to new employees. This issue is especially problematic if the shares are issued in subsequent tranches after the implementation of the share scheme have increased in value. The question therefore arises as to whether the shares of all tranches are valued on the date of implementation of the share scheme or at the point in time when the shares are actually issued to particular employees.

Proposed solution/recommendation

It is submitted that the R50 000 limit be based on the value of the shares when the shares are initially made part of the scheme. This date can be controlled and is close in time to the date of director approval. If there is concern that the time differential creates too much of a value differentiation, one can limit the period to a period of three years.