

The effect and application of section 8C in respect of the Private Equity Industry



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ABSTRACT

Employers have used various means to remunerate, retain and incentivize employees. One of these methods, is through the allocation of ownership in the employer to the employee, which help align the financial interests of the company and the staff member.

SARS and National Treasury regulate the taxation of these forms of remuneration, typically called employee share incentive schemes, through section 8C of the Income Tax Act. A common practice among these schemes, is for the employer to impose some form of restriction on the equity shares issued to the employee, usually limiting the holder's ability to dispose of the instrument. Once an equity share with a restriction is issued to an employee by an employer – section 8C of the Act applies.

These types of structures are prevalent in the private equity industry, but with a slight nuance: the employee will receive an equity share indirectly or directly linked to the private equity fund(s) operated by the private equity fund management company. This provides the staff member with 'skin in the game', ensuring the longevity of the private equity fund can be sustained, and provides a foundation on which a rapport can be built with investors.

The underlying investments in the private equity fund will provide the value of the equity shares in question. In most cases, these amounts will be in capital in nature owing to the length of holding period and the intention with which those investments are acquired. However, the effect of section 8C is to classify the gains on the employees' equity shares as income rather than capital.

The private equity industry finds itself in a precarious position with respect to the long-term equity incentivisation of staff and aligning this with the long-term nature of the fund's underlying investments.

TABLE OF ABBREVIATIONS AND GLOSSARY

In this document, unless the context indicates otherwise –

“**the Act**” means the Income Tax Act, No. 58 of 1962

“**the Trust Act**” means the Trust Property Control Act, No. 57 of 1988

“**the Cisca**” means the Collective Investment Scheme Control Act, No. 45 of 2002

“**the Companies Act**” means the Companies Act, No. 71 of 2008

“**the FAIS**” means the Financial Advisory and Intermediary Act, No. 37 of 2002

Code:	Description:
CGT	Capital Gains Tax
DWT	Dividend Withholding Tax
the Partnership	<i>En Commandite Partnership</i>
the GP	General Partner
PAYE	Pay-As-You-Earn
PE	Private Equity
SARS	the South African Revenue Service
FSB	the Financial Services Board
NT	National Treasury

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1 CHAPTER 1 – INTRODUCTION

1.1 Background

It is arguable that human capital is the greatest driver of efficiency in the work environment, which ultimately brings about profitability and value to organisations across varying industries. In the past, it may not have been uncommon for an employee to spend their entire working career at one organisation, whereas in more recent times employees keep abreast with the job market and shift between organisations with greater frequency¹. For precisely this reason, employers have had to develop and offer more attractive remuneration packages.

Some employers have adopted a policy of remunerating their employees through the allocation of ownership stakes in the employer entity in which employees generate (or have the potential to generate) value. The Income Tax Act² has been amended progressively, with specific rules and provisions on the taxation of such remuneration packages to ensure that these forms of remuneration do not convert amount that is income in nature to capital in nature.

There are several advantages attached to a share-based remuneration package, which benefit both the employee and employer. Firstly, there is a financial benefit to the company as the use of cash is reduced and effectively relieves the cash-flow pressures of an employer. Secondly, it helps align the financial interests of the employee and employer, incentivizing the employee to be more invested in the company and can often foster a stronger connection with the company. Lastly, often these forms of remuneration may significantly reduce the employee turnover of a company. Contrary to this, there are distinct disadvantages attached to a share incentive remuneration packages. Firstly, employee morale and retention could be affected should the employer company's share price decrease (considering that employees have a sense of lack of control over the price). Secondly, there are establishment and administration

¹ Jeanne Meister, Job Hopping Is the 'New Normal' for Millennials: Three Ways to Prevent a Human Resource Nightmare, Forbes Magazine, August 2012

² No. 58 of 1962, hereafter "the Act".

costs attached to these plans for which the employer will need to provide. Lastly, in share incentive plans involving a derivative of some form, the percentage of share ownership becomes diluted upon the issuance of further shares³.

The King III Report on Corporate Governance for South Africa 2009 ('the King III') made it abundantly clear that in order to maintain good corporate governance, while trying to attract and retain high performing employees (although the King III focused largely on executive remuneration packages and structures), the company's remuneration policy must be efficient and competitive. King III emphasized the importance of remuneration in the following principles:

- Companies should remunerate directors and executives fairly and responsibly;
- Companies should disclose the remuneration of each individual director and prescribed officer; and
- Shareholders should approve the company's remuneration policy.

National Treasury ('Treasury') and the South African Revenue Service ('SARS') are aware of the share incentive plans employed by various organisations across the country. The position of this fiscus appears to be that if such plans are not controlled and managed effectively, they could result in employers and employees shifting remuneration that is income in nature into compensation of a capital nature. The effect of such a shift in classification is that the employees pay less tax (given the more benign effective rate of capital gains tax) with diminution of collections by the fiscus.

Within the private equity ('PE') industry, staff members or co-advisors of the PE fund management company are typically made offers to purchase a form of ownership in the PE fund in which they prepare and execute research and conclude deals. The issuance of these ownership stakes will generally be through some form of a special purpose vehicle, which will in turn make an investment into the PE fund. This remuneration package or structure will have

³ Employee Share Ownership, The Advantages and Disadvantages of Employee Share Ownership for a Company and an Employee, February 2012

various restrictions attached to it to ensure the retention of services of these employees and creates a vested interest for the selected staff members.

1.2 Aim of this research

The objective of this dissertation is to set out and explain how the PE industry is affected by section 8C of the Act. To this end, the mechanics of this section of the Act are described. Then, the impact of the provisions of section 8C on specific arrangements (including those relating to staff members, the investment vehicle and the structure's design) concluded are discussed.

There have been numerous amendments to section 8C of the Act since its introduction in 2004. These amendments have resulted in several important considerations for PE fund management companies and their employees. Several important questions are to be examined and discussed in relation to the following specific areas:

1.2.1 Commercial Aspects

The following questions in relation to the relevant commercial aspects of the agreements, arrangements and structures will be addressed: (a) whether the agreements ought to be classed as "restricted equity instruments" (based on what the agreement or arrangement is attempting to achieve); and (b) how the value of these agreements or arrangements is derived.

1.2.2 Tax Implications

In relation to the relevant tax provisions, the issues addressed are: (a) the salient elements of section 8C; (b) how the agreements and arrangements within the PE industry fall within the ambit of the relevant provisions; (c) whether these agreements and arrangements ought to fall within the ambit of section 8C at all; and (d) whether the potential exists for a form of double taxation or a change in the underlying nature of the value derived.

1.3 Structure of the Dissertation

The dissertation is structured as follows:

Chapter two provides the background and analysis into share-incentive plans and the relevant legislation relating thereto. The salient points identified in this chapter are: (a) the requirement for a nexus between the employee and employer; (b) how and when an equity instrument vests in a taxpayer; (c) the differentiation between a restricted equity instrument and unrestricted equity instrument (d) further discussion of the other provisions of section 8C; (e) the recent amendments enacted by the SARS and their intention thereof; and (f) a synopsis of the most prevalent tax court cases to affect the interpretation and implementation of section 8C of the Act.

Chapter three provides a detailed analysis of the most prevalent types of share incentive plans employed by entities within South Africa. This chapter will aid the objective in chapter four regarding the type of share incentive plan that the PE arrangements are most akin to.

Chapter four provides (a) an overview of the structures employed within the PE industry in order to conclude these arrangement and agreements with certain parties; (b) how these structures fall within the relevant provisions of the Act; (c) the way in which the value of the restricted instruments is derived; (d) what type of share incentive scheme these arrangements are most akin too; and (e) if the potential exists for a catalytic change in the nature of income earned.

Chapter five will draw all the above elements together and provide conclusions on the questions and issues raised in each of the chapters described above.

1.4 Research Method

This dissertation constitutes legal research. This includes the answering of the research questions through identifying, analysing and organising tax legislation, court cases and

commentary on legislation and proposed legislation. Chapter four provides simple example explaining how the legislation is applied and chapter three provides a detailed example of the scenario faced by the investors in the staff co-investment *Bewind Trust* or *En Commandite Partnership*.

1.5 Limitations of Scope

The scope of this research paper is limited to the South African income tax treatment of restricted and unrestricted equity shares, partnerships, trusts and individuals within these structures. This research paper includes all the relevant South African legislation promulgated up to the 19th of January 2017. Institutional investors were disregarded in the consideration for this research paper owing to the lack of access to information.

2 CHAPTER 2 – THE OVERARCHING PRINCIPLES OF SECTION 8C

2.1 Introduction

The purpose of this chapter is to provide an overview of section 8C of the Act, with particular emphasis on what the Act defines as an “equity instrument”, what constitutes a restricted equity instrument, how and when the vesting of these instruments occurs, and the structure of the various instruments including a synopsis of the recently promulgated amendments to this particular section of the Act.

2.2 History

Prior to the introduction of section 8C into the Act on 26th of October 2004, section 8A of the Act governed the taxation of rights to or an option to acquire a marketable security by taxpayers. Section 8A of the Act was effectively introduced to tax the granting of such securities, where they were issued below the market value.

In order for the marketable securities to fall within the ambit of section 8A, the taxpayer had to have acquired these securities by either; (a) the rendering of services as an employee or (b) their appointment and role as a director or former director of a company. The rules within section 8A of the Act, required the taxpayer to determine a gain or loss once the right or option granted was exercised, released or abandoned by the taxpayer. The gain or loss is the difference between the purchase price paid for the marketable securities and the current market value on the applicable date (i.e. the date of exercise, release or abandonment).

A proviso exists within section 8A of the Act, which allows the taxpayer to defer the taxability of the gain where a restriction has been placed on the marketable security acquired. The taxing of the gain can be deferred to the year in which the conditions imposed on the disposal of the affected equity instrument are satisfied. For the deferral to take effect, the taxpayer must make an election under section 8A(c) of the Act.

The introduction of section 8C of the Act was in essence, SARS and Treasury's attempt to tax as revenue the gains and losses attributable to shares acquired by (a) virtue of holding directorship; or (b) being an employee through a share incentive plan or structure, irrespective of whether the equity shares were held directly or indirectly or acquired via a derivative mechanism. In the 2004 Explanatory Memorandum to the Revenue Laws Amendment Bill of 2004, SARS stated the following as their reasons for the introduction of section 8C:

“The existing section 8A, enacted in 1969, has failed to keep pace with the myriad of equity-based incentives developed for top management. While these provisions cover any right to acquire a marketable security, the nature of the regime is such that its application is often unclear once top management enter into these schemes that involve share rights beyond simple share options.

The regime also fails to fully capture all the appreciation associated with the marketable security as ordinary income. The regime only triggers ordinary treatment for the amount of appreciation arising until exercise, cession or release of that right, even if the right is converted to a restricted share. This ordinary amount can then be deferred until the restriction on the share is lifted or the share is sold (with the appreciation on the share after conversion left as capital gain). Many of these schemes also seek to manipulate values so that gain is triggered when values are low (or can be artificially depressed).”⁴

This clearly demonstrates the issues SARS have had over the years with share incentive plans and structures. Section 8C is part of set of anti-avoidance measures ensuring that what is in substance a form of income, from being recharacterized as a capital gain or exempt income (such as, dividends which are subject to dividends tax).

⁴ See, Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004

2.3 The Employee – Employer Relationship

For section 8C of the Act to apply, there needs to be a clear nexus between two persons⁵. The presence of an employer-employee relationship is paramount to the application of this section of the Act. This section of the Act is based on the ability of one person, being the employee, to deliver or render a service for another person, the employer. The Fourth Schedule to the Act, defines the term ‘employer’ as being:

“any person (excluding any person not acting as a principal, but including any person acting in a fiduciary capacity or in his capacity as a trustee in an insolvent estate, an executor or an administrator of a benefit fund, pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or any other fund) who pays or is liable to pay to any person any amount by way of remuneration, and any person responsible for the payment of any amount by way of remuneration to any person under the provisions of any law or out of public funds (including the funds of any provincial council or any administration or undertaking of the State) or out of funds voted by Parliament or a provincial council;”⁶

If a person has the status of ‘director’, they would also fall within the ambit of section 8C of the Act. On that basis, it is submitted that independent contractors, for example, agents, auditors or underwriters would not fall within the terms of section 8C of the Act. However, this approach does not mean that the receipt of a right to acquire equity shares by those who do not fall within the ambit of section 8C of the Act, would escape taxation.

It is submitted that from the above, it is imperative that an employer be present for section 8C of the Act to have a taxation effect on the equity instrument acquired by an employee. The definition of an ‘employer’ as per paragraph 1 of the Seventh Schedule to the Act is as follows:

“means any person who is an employer as defined in paragraph 1 of the Fourth Schedule and includes--

⁵ The reference to ‘persons’ include both natural and juristic persons.

⁶ See, Paragraph 1 of the Fourth Schedule to the Act

- a) any company; and
- b) for the purpose of paragraph 2 and the determination of the cash equivalent of the value of any taxable benefit granted to any person who derives remuneration as defined in the said paragraph from employment in the public service or any administration or undertaking of the State or who holds office under the Republic, the State.”⁷

Based on the above definition, the term ‘employer’ is further defined in paragraph 1 of the Fourth Schedule to the Act. The definition reads as follows:

“means any person (excluding any person not acting as a principal, but including any person acting in a fiduciary capacity or in his capacity as a trustee in an insolvent estate, an executor or an administrator of a benefit fund, pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or any other fund) who pays or is liable to pay to any person any amount by way of remuneration, and any person responsible for the payment of any amount by way of remuneration to any person under the provisions of any law or out of public funds (including the funds of any provincial council or any administration or undertaking of the State) or out of funds voted by Parliament or a provincial council;”⁸

The recent issuance of the King IV Report on Corporate Governance for South Africa (‘the King IV’), 2016, focuses on four outcomes with 17 underlying principles. The four outcomes encompass; (a) an ethical culture and effective leadership; (b) performance and value creation in a sustainable manner; (c) adequate and effective controls; (d) establishing and maintaining trust, a good reputation and legitimacy. Principle 14 of the King VI details the necessary governance required by corporates surrounding their remuneration packages for employees. The principle states the following:

“The governing body should ensure that the organisation remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term.”⁹

⁷ See, Paragraph 1 of the Seventh Schedule to the Act

⁸ See, Paragraph 1 of the Fourth Schedule to the Act

⁹ See, Principle 14 of King VI Report on Corporate Governance for South Africa

The primary objectives of Principle 14 are to; (a) attract, motivate and retain human capital; (b) promote the achievable strategic outcomes within the organisations risk appetite; (c) promote positive outcomes; and (d) promote an ethical culture and responsible citizenship. Without delving into the various iterations of section 8C of the Act, the law as it currently stands (prior to the amendments promulgated on the 19th of January 2017) is discussed below.

Once the causal link between the employer and employee has been established, an equity instrument is required to be acquired by the employee to form part of the relationship for section 8C of the Act to take full effect.

2.4 Defining the ‘Equity Instrument’

As a starting point, it should be noted that other sections of the Act and their rules and provisos do not apply to section 8C of the Act. Such as, section 9C of the Act – which states that where any equity share held for a period of greater than three years, the gain or loss will automatically be deemed to be ‘capital in nature’ and taxed under the CGT rules within the Eighth Schedule to the Act. In addition, the limitations described in section 23(m) of the Act on deductions claimed by taxpayers under section 11 of the Act.

The definition of an ‘equity instrument’¹⁰ contained in section 8C of the Act includes (a) a share in a company (whether or not this is an ‘equity share’ as defined in section 1 of the Act); (b) members interest in a closed corporation; and (c) an option to acquire a share in a company or a member’s interest in a closed corporation. It is submitted that an ‘option’ can be loosely defined as a contractual agreement between two parties whereby one agrees to buy a corporeal or incorporeal good at a specified future date and for a specified future price and the other party agrees to the sell that corporeal or incorporeal good on the same terms and conditions¹¹. Also included is, (a) any financial instrument that may be converted into a share

¹⁰ See, section 8C(7) of the Act

¹¹ As per section 24L of the Act, an ‘option is defined as:

“an agreement the effect of which is that any person acquires the option (excluding a foreign currency option contract as defined in [section 24L\(1\)](#)) –

of a company or a member's interest in a closed corporation; and (b) any contractual right or obligation – the value of which is based on a share or a member's interest.

It is submitted that the definition an of 'equity instrument' described above is wide in its application as can be seen through a comparison to the definition provided in section 1 and section 9C of the Act. This is primarily a direct result of its technical manipulation in the past. This broadened approach was enacted in 2008, owing to the growing use of trusts in the formulation and administration of share incentive schemes whereby the ultimate beneficial owner reaped all the value and benefit without holding the outright ownership to the instrument upon which the value was derived. For an 'equity instrument' to be encapsulated by section 8C of the Act, it must fall within the definition provided above.

Once the instrument has been defined, one must determine whether restrictions have been imposed before the equity instrument constitutes a 'restricted equity instrument'. This is discussed below.

2.5 What constitutes a Restricted Equity Instrument

A complete understanding of the definition 'restricted equity instrument' is paramount to the determination of when the taxable event of vesting has occurred for a person. As per section 8C (7) of the Act, a 'restricted equity instrument' is one that is subject to one of the following provisions:

- Which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;
- Which is subject to any restriction that could result in the taxpayer—
 - Forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or

(a) to buy from or to sell to another person a certain quantity of corporeal or incorporeal things before or on a future date at a pre-arranged price; or

(b) that an amount of money will be paid to or received from another person before or on a future date depending on whether the value or price of an asset, index, currency, rate of interest or any other factor is higher or lower before or on that future date than a pre-arranged value or price."

- Being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;
- If any person has retained the right to impose a restriction contemplated in paragraph (a) or (b) on the disposal of that equity instrument;
- Which is an option contemplated in paragraph (a) of the definition of 'equity instrument' and where the equity instrument which can be acquired in terms of that option will be a restricted equity instrument;
- Which is a financial instrument contemplated in paragraph (b) of the definition of 'equity instrument' and where the equity instrument to which that financial instrument can be converted will be a restricted equity instrument;
- If the employer, associated institution in relation to the employer or other person by arrangement with the employer has at the time of acquisition by the taxpayer of the equity instrument undertaken to—
 - Cancel the transaction under which that taxpayer acquired the equity instrument;
 - or
 - Repurchase that equity instrument from that taxpayer at a price exceeding its market value on the date of repurchase,
 If there is a decline in the value of the equity instrument after that acquisition; or
- Which is not deliverable to the taxpayer until the happening of an event, whether fixed or contingent;

In addition, any equity instrument granted that is not subject to one of the above will be defined as an 'unrestricted equity instrument' and any subsequent gain or loss will be assessable on the date of acquisition and not on the date of vesting.

At a specific point in time the taxpayer becomes the beneficial owner of a 'restricted equity instrument', and effectively becomes liable for the obligations and benefits attached to the instrument. This point in time is detailed below.

2.6 Vesting of the 'Equity Instrument'

The most notable change in the taxation of share incentive schemes upon the introduction of section 8C to the Act, was the insertion of the concept of 'vesting' and the shift away from the concept of 'transfer of ownership'. It is submitted that the concept of 'vesting' provides the time and manner in which taxpayer becomes liable to disclose his or her gain or loss on a section 8C equity instrument.

In terms of section 8C (3)(a) of the Act, an unrestricted equity instrument will vest on the date on which the taxpayer acquires the equity instrument. Conversely under section 8C (3)(b) of the Act, restricted equity instruments (discussed in 2.5) vesting occurs when –

- All restrictions imposed on the instrument (causing it to be a restricted equity instrument – discussed in detail below) have been fulfilled or lifted;
- Immediately prior to disposal by the taxpayer of the restricted instruments excluding disposals to connected persons, non-arm's length transactions and disposals whereby a portion of the proceeds includes the receipt of another restricted equity instrument;
- Immediately after an option is terminated or a convertible financial instrument is converted;
- The date on which an option or convertible financial instrument lapses, is released or abandoned by the taxpayer; and
- Immediately before the death of the taxpayer provided the restrictions will be lifted upon or after death.

Upon the vesting of the equity instrument, the gain or loss must be determined by the employee and assessed. In terms of subsection 2 of section 8C of the Act, the gain or loss is the amount by which the market value exceeds the amount of consideration paid by the employee (an example is provided below).

The acquisition of an equity instrument will only lead to a taxable event once the vesting has occurred. Any gain determined in the year of vesting will constitute remuneration, as defined in paragraph 11A (1) of the Fourth Schedule to the Act and will be subject to Pay-As-You-Earn

(‘PAYE’) ¹². The employer (upon notification of the vesting of the instrument) must apply to the Commissioner of SARS for a tax directive, with specific reference to the amount of PAYE to be withheld. Any loss sustained on the vesting of the equity instrument will be deductible from the taxpayer’s taxable income.

In terms of paragraph 11A (7) of the Fourth Schedule to the Act, if an employee fails to inform the employer of any gain received or accrued upon the vesting of an instrument, the employee could be guilty of an offence and liable for a fine of R 2 000¹³.

Example:

If Company XYZ gives an employee, the option to purchase 1000 shares in the employer at a price of R 50 per share. The employee accepts but the shares are subject to a deferred delivery period of five years (i.e. the shares that the employee accepts to purchase are restricted). On the lapsing of the five-year period, the employee pays R 50 000 for the shares.

At the end of the five-year restriction period, the market value of the shares is equal to R 110 per share. The employee will be subject to PAYE on the gain upon vesting of R 60 000, which is the current market value of R 110 000 less the purchase price of the shares, being R 50 000.

2.7 Capital Gains Implications

Within the Act, there are specific provisions that provide the holder of an equity share with certain safe harbour rules. Section 9C of the Act deems any gain or loss upon the disposal of an equity share from income to be capital in nature, provided specific holding period requirements are met. Firstly, it is important to determine what constitutes an equity share under section 9C of the Act. An “equity share” is defined in section 1 of the Act as being:

¹² See, paragraph 11A(1) of the Fourth schedule to the Act

¹³ See, paragraph 11A(7) of the Fourth Schedule to the Act

“means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution;”¹⁴

The above definition is further expanded in section 9C of the Act, to incorporate any participatory interests held in a portfolio of collective investment scheme in securities and hedge funds. The following sharers are excluded from the definition:

- a share in a share block company as defined in section 1 of the Share Blocks Control Act;
- a share in a company which was not a resident, other than a company contemplated in paragraph (a) of the definition of "listed company"; or
- a hybrid equity instrument as defined in section 8E;

Secondly, the time with which the equity shares must be held is a continuous period of three years. The measurement of this holding period needs to be recorded specifically, especially for persons trading in and out of a specific equity share on a regular basis. To determine the specific holding period of each equity share, a taxpayer must select either, FIFO (First In-First Out), weighted average (pooling mechanism) or specific identification. This method must be applied consistently throughout the taxpayer's computations.

Provided the equity shares held meet the definition provided in section 9C of the Act and have been continuously held for a period of three years, the gain or loss upon disposal will under section 9C (2) of the Act be 'capital in nature' and subject to the provisions of the Eighth Schedule to the Act. The gain or loss on disposal of the equity shares will be equal to the difference between the proceeds received and the consideration paid by the employee.

Example:

Based on the facts from the example above, where the employee had purchased shares at the end of five-year period and been subject to PAYE on the gain upon vesting of R 60 000. In terms of paragraph 20(1)(h) of Schedule 8 to the Act, if the employee had to dispose of half of

¹⁴ See, section 1 of the Act

the shares (500) during the tax year following the year of vesting for their current market value of R 175 per share. The base cost attached to the shares disposed of will be R 55 000 with the employee enjoying a gain of R 32 500 (proceeds of R 87 500). The gain upon disposal will be subject to the CGT rules with forty percent¹⁵ of the gain being included in the employee taxable income.

2.8 Other Notable Provisions

2.8.1 Distributions in relation to Section 8C

From 01 April 2012, a return of capital or return of foreign capital (hereafter referred to as 'return of capital') is received as a result of holding a restricted equity instrument – under the provisions of section 8C (1A) of the Act the taxpayer must include in his or her gross income the amount of the return of capital in the year of receipt or accrual. Under section 1 of the Act, a 'return of capital' is defined as meaning:

“any amount transferred by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company to the extent that that transfer results in a reduction of contributed tax capital of the company, whether that amount is transferred –

- a. by way of a distribution made by; or
- b. as consideration for the acquisition of any share in, that company, but does not include any amount so transferred to the extent that the amount so transferred constitutes –
 - i. shares in the company; or
 - ii. an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements;”¹⁶

¹⁵ As per <http://www.sars.gov.za/TaxTypes/CGT/Proceeds/Calc-Tax-Capital/Pages/Inclusion-rate.aspx>

¹⁶ See, section 1 of the Act

Traditionally, the receipt of a return of capital would have been considered a part disposal¹⁷ under the Eighth Schedule of the Act, consistent with the definition stated above. The taxpayer would lower their base cost of the equity instrument and effectively pay a higher amount of CGT on the gain upon disposal or obtain a lower CGT loss available from set-off against other taxable CGT gains.

As displayed in the 2004 Explanatory Memorandum to the Revenue Laws Amendment Bill of 2004, the applicability of section 8C of the Act is based on services rendered by an employee to an employer. For which an employee would receive remuneration, which is income in nature. The inclusion of a return of capital in income of the employee then follows the same principle.

In spite the exempt status of dividends, certain dividends received in respect of restricted equity instruments (provided the equity instrument was acquired or granted in terms of section 8C of the Act), unless, generally speaking, (a) the restricted equity instrument constitutes an equity share; (b) the dividends constitute an equity instrument; or (c) the restricted equity instrument constitutes an interest in a trust, and the trust holds equity shares – are taxable as income.

2.8.2 Rollover Provisions

In the situation where a taxpayer disposes of the restricted equity instrument(s) held, and the proceeds of that disposal consist of the receipt of any other restricted equity instrument in the employer, associated institution in relation to the employer. The 'new' restricted equity instruments are deemed under section 8C (4)(a) of the Act to have been received by virtue of his or her employment.

By its very nature, it is submitted, that there is no vesting of the disposed of restricted equity instruments and vesting will occur when the restrictions placed on the newly acquired restricted equity instruments are fulfilled, cease to exist or any other action triggers the vesting.

¹⁷ See, paragraph 76 of the Eighth Schedule to the Act

This is supported by paragraph 64C of Schedule 8 to the Act, which states that any capital gain or loss must be disregarded in the scenario detailed in section 8C(4)(a), (5)(a) or (5)(c) of the Act. Therefore, the receipt of a restricted equity instrument for the disposal of a restricted equity instrument will be treated as a non-taxable event.

Should the taxpayer receive a cash component as part of the proceeds from the disposal of the original restricted equity instruments acquired, then a part disposal must be computed. Under section 8C(4)(b) of the Act this part disposal will be subject to PAYE. It is submitted that the reading of this section would infer that there is a deemed vesting of the restricted equity instruments disposed of. This deemed vesting would only apply to the instruments to which the cash component relates to.

Example:

If Company XYZ gives an employee, the option to purchase 1000 shares in the employer at a price of R 50 per share. The employee accepts but the shares are subject to a deferred delivery period of five years (i.e. the shares that the employee accepts to purchase are restricted).

If the employee after three-years disposes of half of the shares (not yet acquired) for a further 750 restricted equity shares in an associated entity (with a current market value of R 100 per share) and receives R 20 000 in addition to the further shares. The cash portion represents twenty-one percent of the total proceeds and the base cost will be determined in the same ratio. The employee will have gain of R 14 736 subject to PAYE under the Fourth Schedule to the Act, due to the part disposal.

2.8.3 Other Transactions

There are several other manners in which a taxpayer can dispose of the restricted equity instruments acquired or granted to them by the employer. Special anti-avoidance provisions have been included in section 8C of the Act to ensure these disposals are caught within the ambit.

2.8.3.1 Non-Arm's Length Transactions

Before proceeding with the taxation of transactions of this nature, it is important to determine what SARS considers to be an arm's length transactions. Any transaction between "connected persons" or transactions not concluded at market value are considered to be a non-arm's length transaction. The term "market value" is defined in paragraph 31(1)(g) of Schedule 8 to the Act as:

"(g) any other asset, the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market." ¹⁸

The term "connected person"¹⁹ is defined in section 1 of the Act and in terms of its applicability to section 8C of the Act, would include any relative of the employee or a trust of which the employee is a beneficiary or any relative of that employee is a beneficiary (excluding portfolios of collective investment schemes).

Therefore, in terms of section 8C(5)(a) any disposals to a connected person or at a value not representing the market value of the restricted equity instrument would mean the person acquiring the restricted equity instruments would still be subject to the provisions of section 8C of the Act. The acquirer would need to compute a gain or loss upon the date of vesting.

2.8.3.2 Acquisitions by Related Parties

Where a restricted equity instrument is acquired by a person by virtue of another person's directorship or employment, the employee is deemed to have acquired the instrument and disposed of it under a non-arm's length transaction and the holder of the instrument will then be subject to the provision of section 8C (2), (3) and (4) of the Act.

¹⁸ See, paragraph 31(1)(g) of Schedule 8 of the Act

¹⁹ See, definition of "connected person" in section 1 of the Act

Effectively, the acquirer is treated in the same manner as the employee would have been taxed had he or she acquired the equity instrument themselves. In Interpretation Note No. 67, SARS notes that the timing of when a person be determined to be a connected to another, is noted in each section of the Act²⁰ referring to connected persons. For the purposes of section 8C of the Act, the timing of the test will be prior to the conclusion of the transaction.

The practical and legislative principles of section 8C of the Act have been discussed. It is necessary to discuss the positions of the employer including a reference to its responsibilities.

2.9 Position of the Employer

Having outlined the main principles of section 8C of the Act, it is necessary to consider the position of the employer in this respect. Although the entire premise of section 8C of the Act revolves primarily around the income tax position of the employee, it also affects the employer who is required withholding of income tax.

In practice, the employer will have designated the governance of the share incentive plan to some form of committee within the organisation. Their primary responsibility will be to provide final authority on which employee will be eligible to participate in the plan, the quantum of awards to be made to these participating employees, the performance criteria applicable to determine the eligible employees, and other matters relating to the governance of the plan.

It is assumed that the employer company would for the purposes of section 1 of the Act to be deemed to be 'carrying on a trade' and for the purposes of producing income. The employer remains responsible for the settlement of the benefits to be affected in terms of the plan, particularly upon vesting date. This is when the employer's responsibilities will materialize. The employer may elect to follow one of the following settlement methods (this list is not exhaustive):

²⁰ See, paragraph 3.9 of Interpretation Note No. 67

- Make a payment to a third party (potentially a trust) and that outside party will acquire the requisite number of equity shares on the market and deliver those shares to the participants of the plan;
- Acquire the relevant number of equity shares at either par or market value from the company directly; and
- Pay the employees the requisite amount of cash *in lieu* of the shares who in turn subscribe for the shares.

For the purposes of the employer claiming a deduction of the amount transferred or applied for the benefit of the participants of the plan, the usual principles within section 11(a) of the Act will need to be adhered to. For the purposes of determining taxable income by any person from the carrying on any trade, the Act shall allow a deduction from income any expenditure and losses actually incurred by the taxpayer in the production of income, provided those amounts are not capital in nature²¹.

Section 11(a) of the Act must be read in conjunction with section 23(g) of the Act. The latter prohibits a deduction of expenditure in the scenario where this was not expended for the purposes of trade. In the case of *Port Elizabeth Electric Tramway Company Limited v Commissioner for Inland Revenue*, the court concluded that expenditure does not produce income, but actions do. One must ascertain how closely linked the expenditure is the actions performed. Watermeyer AJP went onto say:

“the purpose of the act entailing expenditure must be looked to. If it is performed for the purposes of earning income, then the expenditure is attendant upon it is deductible...”

The other question is, what attendant expenses can be deducted? How clearly must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purposes of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided

²¹ See, section 11(1)(a) of the Act

they are so closely connected with it that they may be regarded as part of the cost performing it.”²²

Therefore, the obligation must exist for the employer to incur the expenditure.

In addition, section 23H of the Act defers the benefit of the deduction in the situation where all or part of the goods, services or benefits are only realised after the end of the year in which the expenditure was incurred²³. If section 23H of the Act is applied to the amount the employer claims as a deduction for the amount transferred or applied for the acquisition of equity shares on behalf of the employees. The deduction would be spread out over the time period taken for the employees to enjoy the benefit of the equity shares (i.e. between the date of incurral and the final date of vesting of the equity shares). As the underlying nature of the deduction is a payment for services rendered to the employer, the deferral of the deduction is to ensure the benefits of the services to be rendered are in fact received by the employer and match the period within which the deduction is claimed by the employer.

It is submitted, that provided the incentive share plan is implemented and structured correctly, the amount incurred by the employer will be tax deductible subject to the nuisances discussed above. Although the views expressed in binding private rulings cannot be relied upon in the same manner as legislation, they do provide insight into SARS’s interpretation and implementation of the legislation.

This submission is confirmed through the inspection of Binding Private Ruling No. 50²⁴ whereby an employer created five share incentive trusts for the for the sole purpose of remunerating employees. The employer made cash grants to the respective trusts to acquire shares for allocation to employees. SARS states in the ruling that the cash grants will be deductible under section 11(a) and subject to section 23H of the Act, respectively.

²² See, Port Elizabeth Electric Tramway Company Limited v Commissioner for Inland Revenue (1936 CPD 241), 8 SATC 13

²³ See, section 23H of the Act

²⁴ See, Binding Private Ruling No. 50, issued by SARS on 16 October 2009

2.10 Recent Amendments to Section 8C of the Act

The current set of provisions within section 8C have certain limitations to it. These limitations implicitly revolve around the distributions effected prior to an equity instrument being unrestricted. These distributions, whether in the form of a return of capital or dividend, effect the underlying value of the restricted equity instrument. Due to the manner in which the definitions of 'return of capital'²⁵ and 'foreign return of capital'²⁶ are worded, the return of capital through the distribution of equity shares is specifically excluded and therefore, falls outside the ambit of section 8C of the Act. This is contrary to the entire premise of section 8C of the Act, which aims to tax all amounts as income in nature provided these amounts are received or accrued due to the holding of a restricted equity instrument.

The legislation, and in particular section 8C (1A) of the Act was amended to the extent that the person holding a restricted equity instrument is required to include any amount received or accrued in their gross income. Provided that amount does not constitute another restricted equity instrument, which is dealt with under section 8C (4)(a) of the Act.

Another mechanism used by corporations to erode the value of the underlying equity instruments, is through the distribution of dividends. The current provisions do not cater for the receipt or accrual (by a restricted equity instrument holder) of the following dividends consisting of or derived from:

- Proceeds from the disposal or redemption of –
 - The underlying equity shares; and
 - The shares from which the above equity shares derive their value.
- The liquidation of a company from which those equity share derives their value.

The amendment of section 8C (1A) includes the inclusion by the holder (of the restricted equity instrument) in their income any amount received or accrued that does not constitute a

²⁵ See, definition of "return of capital" in section 1 of the Act

²⁶ See, definition of "foreign return of capital" in section 1 of the Act

‘dividend’ or ‘foreign dividend’. This amendment will encapsulate any amount earned that would erode the value of the underlying equity shares.

Within section 10 of the Act, currently, certain dividends are exempt from normal income tax. In order to combat this, a new proviso was added to section 10 (1)(k) of the Act which ensures the following amounts received or accrued are not exempt from normal income tax:

- An amount received as consideration for the acquisition or redemption of any share in the company in which the restricted equity instruments are held; and
- An amount received in the process of winding up, liquidating, deregister or the final termination of the company in which the restricted equity instruments are held.

The amendments mentioned above (promulgated more than 10 years after section 8C’s introduction into the Act) clearly demonstrate that Treasury and SARS are still attempting to stay a pace with the work of the corporations implementing these share incentive plans and the advisors aiding these entities.

Due to the significance of the Bosch²⁷ case and clarity it provides by discussing the application and interpretation of section 8C of the Act, it is explored in detail below.

2.11 The Bosch Case

The Bosch²⁸ case was brought on appeal of ITC 1856 to the Supreme Court of Appeals and was based on an additional assessment raised by SARS on 171 Foschini employees who had benefitted from a share incentive plan. Foschini implemented deferred delivery share scheme in 1997 for specific employees, two of which, Ms Bosch and Mr. McClellan were both beneficiaries of the plan. In terms of the plan, options were granted to staff which had to be exercised within 21 days of their offering. The delivery and payment of the underlying shares would occur in three tranches (on the anniversary of the notice) after exercising the option:

- Two years;

²⁷ Commissioner SARS v Bosch (394/2013) [2014] ZASCA 171 (19 November 2014)

²⁸ Commissioner SARS v Bosch (394/2013) [2014] ZASCA 171 (19 November 2014)

- Four years; and
- Six years.

Upon delivery of the underlying shares, the employees were required to effect payment for these. Or alternatively, the shares could be sold on the open market, as Lewis Foschini Investment Company Ltd (here after referred to as 'Foschini')²⁹ was listed. If the employee opted for sale, then the balance of sale proceeds less the cost of sale and purchase consideration was given to the employee. Until the point of delivery and payment of the shares, the employees could not pledge, transfer, cede or encumber the shares in any manner. Nor did any of the rights or benefits attached to the shares flow to the employees. There was a stop loss provision built into the agreement, whereby the employees could dispose of the share back to the trust if the market value decreased below the future purchase price.

Ms. Bosch elected to dispose of her shares and Mr. McCellan opted to purchase the underlying shares. The employees were assessed on the date on which the option was exercised (between September and December 1998), which meant the market value of the shares was much lower than at the date of actual delivery and payment of the underlying shares. The court concluded that the first two tranches of share delivery and payment were in accordance with the legislation and practice at the time, and the Commissioner for SARS had no contentions to these. The additional assessments were raised on the third and final delivery of shares.

The primary issue of contention between the taxpayers and the Commissioner for SARS was whether the right granted to acquire shares in Foschini was exercised when they exercised the option or at the point of delivery and payment, as the taxpayers effectively still had a right to sell upon date of delivery instead of physical acquiring the shares in Foschini.

²⁹ The entity within which the employees received shares was the Lewis Foschini Investment Company Ltd, the listed holding company of Foschini.

When the Bosch case was on appeal with the High Court, the meaning of the word “rights” was reexamined with reference to the Kirsch³⁰ case. In the Kirsch case, there was an allotment of shares and not an option to acquire shares. But the premise that prevailed, as delivered by Coetzee J, that the act of acceptance of the offer in the case of an option or the acceptance of an offer to allot shares were both acts that give rise to a potential tax liability.

Based on the above principles established in the Kirsch case, the Commissioner for SARS was made to concede that the deferred delivery and payment of the underlying shares did not create suspensive conditions in the agreement of sale and that the unconditional sale of share to the employee occurred when the option to acquire the shares was exercised. What is important to note is, that had section 8A of the Act been scripted that “acquire” did not occur until the person had fulfilled all his or her obligations, no need would exist for the differentiation of restricted and unrestricted equity instrument as is currently drafted in section 8C of the Act.

Post this, the Commissioner for SARS sought to rely on the judgment in the NWK³¹ case. The NWK case primarily hinged on the concept of ‘substance over form’, which is addressed in sections 80A – L of the Act under the General Anti-Avoidance provisions. The Commissioner for SARS was of the view that the transaction that Foschini had entered into with their employees was of simulated nature. As there was sufficient uncertainty regarding the deliverability and execution of the acquisition of the underlying shares by the employees to demonstrate the unconditional right to the shares. Had the court accepted this argument, the Commissioner would have had grounds on which to apply the provisions of section 8A of the Act at the point of delivery and payment of the shares.

The court was of the view that the principles of the NWK case could only be applied in a scenario where a transaction attempts to demonstrate a commercial rationale where there is in fact no commercial rationale or substance. The fact that the transaction tried to obtain the lowest amount of tax, does not mean the entire transaction was simulated. The High Court

³⁰ Secretary for Inland Revenue v Kirsch 1978 (3) SA 93 (T) at 95B-E.

³¹ Commissioner for SARS v NWK Ltd [2011] 2 All SA 347 (SCA)

overturned the decision of the Income Tax Court and ruled that section 8A of the Act applied at the point of when the employees exercised the option to acquire the shares in Foschini.

Due to the popularity and ease of administration of a trust for a vehicle in which to house a share incentive scheme, the use thereof is discussed below with specific reference to how these vehicles are encapsulated within section 8C of the Act.

2.12 The use of Trusts

Over the years, the use of a trust has been a popular vehicle for the structuring of share incentive plan. The share trust has many benefits to the employer, not all related to tax. It is administratively easier to have the shares in a trust for the benefit of the employees. There is more certainty in terms of shareholdings, as the employer does not a on regular basis need to issue new shares as and when the employee become eligible and subscribe. In addition, the entity is separate to the employer in terms of insolvency.

Section 8C of the Act will only apply to the equity instrument acquired by an employee due to his or her employment. The interposition of a trust requires there to be a causal link between the equity instrument held by the employee and their employment. The scope of section 8C of the Act includes equity instruments acquired from the employer, an associated institution in relation to said employer, any other person employed by the employer or above-mentioned associated institution. The definitions ascribed to 'employer' and 'associated institution' in section 8C of the Act, refer to the same definitions provided for in paragraph 1 of the Seventh Schedule to the Act.

The inclusion of these definitions cast the net of section 8C of the Act wider than its predecessor, section 8A of the Act. This wider approach will affect transactions where an employee acquires an equity instrument from a share trust, rather than the direct acquisition from an employer. It is submitted that for employees participating in share incentive trust to fall within the ambit of section 8C of the Act, a causal link needs to exist between the equity instruments held by the employee and the employee's employment.

In terms of the above, it is important to note the definition of an ‘associated institution’ to ensure the applicability of section 8C of the Act to equity instruments acquired indirectly through a share incentive trust. The definition contained in paragraph 1 of the Seventh Schedule to the Act reads as follows:

“in relation to any single employer, means—

- a) where the employer is a company, any other company which is associated with the employer company by reason of the fact that both companies are managed or controlled directly or indirectly by substantially the same persons; or
- b) where the employer is not a company, any company which is managed or controlled directly or indirectly by the employer or by any partnership of which the employer is a member; or
- c) any fund established solely or mainly for providing benefits for employees or former employees of the employer or for employees or former employees of the employer and any company which is in terms of paragraph (a) or (b) an associated institution in relation to the employer, but excluding any fund established by a trade union or industrial council and any fund established for postgraduate research otherwise than out of moneys provided by the employer or by any associated institution in relation to the employer;”³²

A share trust structured for the sole purpose of administering the share incentive scheme for the benefit of employees on behalf of the employer, will fall within the ambit of paragraph (c) of the above definition and would be classed as an associated institution in relation to the employer. Therefore, any equity instrument acquired or granted to an employee by the share incentive trust would fall within the scope of section 8C of the Act.

It is submitted that from a practical and operational perspective, the trust is created for the benefit of the participants being a class or specific set of employees. The employer will make a cash contribution to the trust for the trust to subscribe for an allotment of equity shares. Those equity shares are held in trust on behalf of the specific employees pending the fulfilment of the

³² See, Paragraph 1 of the Seventh Schedule to the Act

incentive plan requirements. Generally, the employer will be afforded the benefit of claiming the contribution as a tax deduction. Such requirements typically range from a specific employment period or performance criteria. Throughout the duration of the share incentive plan, the dividends will flow to the trust who (the trustees) will determine based on the provision within the trust deed whether the dividends will be used to repay the contribution made by the employer or given to the employees directly.

2.13 Conclusion

It is clear from the wording of section 8C of the Act, that for it to apply, an employee needs to render a service and the employer must reciprocate with some form of remuneration for the services performed by the employee. The form of remuneration must fall within the definition provided in paragraph 1 of the Fourth Schedule to the Act.

It is submitted, that an equity instrument will vest once all conditions and obligations attached to the equity instrument or derivative thereof have been fulfilled and settled. The employee will either dispose of the instrument or become the ultimate beneficial owner of said equity instrument. The vesting event is a by-product of imposing restrictions, conditions and/or obligations on the equity share based remuneration to the employee. The beneficial ownership of the underlying equity instrument is based on a future fixed or contingent event. An equity instrument that does not have any of the above imposed on, will vest upon ownership and the gain or loss must be considered for the purposes of Fourth Schedule to the Act, at that point in time.

The remaining provisions of section 8C of the Act, cover the way in which distributions must be treated for the purposes of income tax, disposals where the proceeds consist of further restricted equity instruments, non-arm's length transactions and disposals to connected persons. These provisions ensure that the premise of section 8C of the Act is maintained, by categorising all gains and losses as income in nature and holding one party accountable for the taxation on these gains and losses.

The recent amendments enacted through the 2016 Tax Laws Amendment Bill were a clear indication that SARS have had a surmountable task in maintaining pace with the way in which the employer and their advisors implement and structure the varying share incentive plans. Chapter three provides a short overview of the five most prevalent types of share incentive plans employed by various employers with the potential taxation effects of each.

3 CHAPTER 3 – COMMON TYPES OF SHARE INCENTIVE SCHEMES

3.1 Introduction

This chapter analyses and provides an overview of the most common types of share incentive plans used by employers to remunerate employees. It is assumed that the below share incentive plans will be offered directly to the employees or indirectly through the issuance of units or a beneficial interest in a share trust vehicle.

3.2 Share Option Schemes

Share Option schemes are structured with relative ease and their costs of implementation are low. The plan merely requires a contract between employee and employer company setting out the terms of the option. The terms of the option will generally include the number of equity shares the employee may subscribe for, the period within which the whole or parts of the options must be exercised within, the price payable per equity share and the date upon which the purchase is payable, if not payable immediately upon exercising the option.

The board of directors of the employer company will determine the employees who qualify for the potential of an option granting and the number of equity shares each option shall be subject to. This will be ratified through a board resolution.

The option will usually be granted at the current market value of the equity shares at the date of offering the option to the employee, although it is no uncommon for options to be granted at nominal prices. The employee will only be required to effect payment for the equity share upon exercising of the option. Once the full purchase consideration has been settled by the employee, the delivery of share will be affected. The purchase consideration can be settled in full, through the use of the employees' own funds or the employer may offer assistance through the form of a loan. Where a loan is issued to the employee, the equity shares will be held as pledge until the loan is fully repaid.

In these types of share incentive plans, the full ownership to the equity shares will only be transferred to the employee once the option has been exercised and full payment for the equity shares has been received by the employer. Therefore, no benefits such as voting rights or dividends will accrue to the employee prior to such event.

For the above share incentive option to fall within the ambit of section 8C of the Act, there needs to exist some form of restrictive condition as described in the definition of a 'restricted equity instrument' in section 8C (7) of the Act. For example, as described in Binding Class Ruling No. 25³³ where an employer structured a share option plan where qualifying employee(s) were awarded options to acquire equity shares. The options were only exercisable after the second-year anniversary after granting and thereafter exercisable in the following tranches:

- Twenty percent after the second-year anniversary;
- Twenty percent after the third-year anniversary;
- Thirty percent after the fourth-year anniversary; and
- The balance is exercisable post the fifth-year anniversary.

All options had to be exercised within a ten-year period after the date of granting. There must exist some form of restriction on the equity shares acquired once the option is exercised for section 8C of the Act to apply.

Most commonly, the price attached to the option granted will represent the fair value³⁴ or market value. Where the equity shares attached to the option granted are newly issued, the price will be the par value of the shares. The employer does hold the discretion to offer the employees an option price that is lower than market value. In terms of the principles established in the *Brummeria Renaissance*³⁵ case, where the court held that the granting of an interest free loan constituted an accrual to the borrower in relation to the definition of "gross income". The employee will be subject to tax on the discount received (the difference between

³³ See, Binding Class Ruling No. 25, issued by SARS on 25 January 2011

³⁴ The term "fair value" is defined in International Financial Reporting Standards 13: Fair Value Measurement as being: "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

³⁵ *South African Revenue Services v Brummeria Renaissance (Pty) Ltd* [2007] (69 SATC 205)

the current market value and the granted purchase price) on the option to acquire the equity share below market value.

3.3 Deferred Delivery Share Plan

Within a deferred delivery share incentive plan, employees are granted the same rights and benefits as in the share incentive option plan. The employer or share trust offers the employee an option, once again subject to certain criteria before the employee qualifies for the granting of an option. The option will specify the number of equity shares the employee is eligible for upon exercising and the fixed price payable for the equity share on the specified future date.

However, in the case of a deferred delivery share incentive plan, the option can be exercised at the date of granting to the employee. The employee is then given an extended period under which the full purchase consideration must then be settled and there is usually no need for the use of loan. The scheme will be predominantly cash settled. The delay in payment and no existence of a loan facility from the employer or share trust, is the major difference between a deferred delivery share incentive plan and the share option incentive plan.

Although the settlement of the purchase consideration is deferred over an extended period of time, the employee will be required to exercise the option within short period of time post the granting of the option and prior to the option lapsing. The deferred settlement will mean the employee will only take full ownership and delivery of the equity shares upon full settlement of the purchase consideration. As was discussed under the share option incentive plan, no voting rights or dividends will be for the benefit of the employee until such time as full ownership is transferred to the employee.

It is submitted that the employee (under a deferred delivery scheme) will face taxable events at the following points in time:

- Vesting of the equity shares in the employees' hands;
- Upon receipt of dividends declared by the scheme post vesting date of the equity shares; and

- Disposal of the equity shares post vesting date of the equity shares.

Due to the period with which the in delivery of the equity shares is delayed, this deferred delivery will constitute a restriction and classify the equity shares as a 'restricted equity instrument' in terms of section 8C of the Act. The instrument upon vesting will then be subject to normal income tax dependent on whether a gain or loss has been experienced by the employee.

3.4 Share Purchase Schemes

The share purchase scheme operates through a share trust whereby the equity shares are acquired by the trust for the benefit of the employees. The purchase of the equity shares in the employer company is usually financed through a loan granted by the employer. The loan must be provided by the employer company at the official rate of interest to ensure the newly promulgated provisions with section 7C of the Act³⁶ do not apply.

As is envisioned in the share option plan, the employees are granted the right to acquire a certain number of share from the share incentive trust. The difference between the share option plan and the share purchase plan is that the employees will acquire the share from the share trust either through direct settlement of the purchase consideration or through financing in the form of a loan from the share incentive trust. The loan will be offered to the employee at a market related rate of interest, in order for the share incentive trust to service its loan with the employer company. Should these loans not be offered at official rate of interest, the provisions within the Seventh Schedule will apply and the employee will be deemed to have received a fringe benefit which will be taxable. The two sets of loans, from the employer company to the share purchase trust, and from the share purchase trust to the employee will match up. The trust therefore, merely acts as a conduit for the employees to purchase the equity shares.

³⁶ See, section 7C of the Act

The ownership of the equity shares will be passed onto the employees upon purchase (either through settlement of the full consideration or purchased through a loan). The equity shares will vest once all restrictions cease to exist. Any dividends accruing will be paid to either the employer to settle any employees' tax due and payable or to the share purchase trust for the settlement of the outstanding loan balance, if applicable. In the Companies Act, No. 61 of 1973, the provision of financial assistance by an employer was prohibited and the use of a conduit in the form of share incentive trust was measure of circumventing this. In the current Companies Act³⁷, under section 97, this limitation has been lifted where a share incentive trust is involved. The provisions of section 97³⁸ of the Companies Act stipulate that certain standards need to be adhered to where an employee share scheme has been established regarding the compliance and administration of the scheme.

3.5 Phantom Share Schemes

Phantom share plans are often used by unlisted companies to remunerate employees. The phantom share scheme differs materially from that of the share option, deferred delivery and share purchase plans due to the employees being offered the right to acquire units (phantom shares) in a share trust, the value of which is linked to the share capital of the employer company. In essence, this plan grants an employee the right to receive some form of cash at some future point in time.

The phantom share scheme is otherwise known as the share appreciation right plan or bonus plan, and no actual shares are issued by the employer company. This ensures there no dilution in the employer and existing shareholders current share capital. There are several other advantages attached to the establishment of a phantom share scheme, being:

- The simplicity in establishment and administration;
- The avoidance of any shareholder or regulatory compliance requirements; and
- The employees' receipt of cash in place of equity shares.

³⁷ Companies Act, No. 71 of 2008

³⁸ See, Section 97 of the Companies Act

Prior to the establishment of a phantom share scheme, a performance benchmark establish will be developed, which will determine how many units the employee will be entitled to receive. The units issued to the employee often have two rights attached to them, providing the employee with an entitlement to participate in the growth the employer company's net asset value and grant the employee the benefit of any dividend declarations made by the employer company. Through the rights, the employees have a vested interest in the success and growth of the employer company.

These units in the share trust could be offered as a substitute for an annual bonus. Some employers provide the employee with the option of exchanging their annual bonus for units in the phantom share scheme. Upon the granting of the units, there will be some form of contractual agreement concluded between the employee and the employer company detailing the pertinent details surrounding the transaction.

In said schemes, the employee will not hold the units indefinitely as is seen in a scheme providing the employee with an actual equity share. The units will have a defined expiry date, at which point the employee will be paid out the market value attached to the units, along with the proportion of appreciation or growth experienced by the employer company since the date of issuance. The phantom share scheme has a rolling effect in that new units may be issued each year or at periodic intervals upon expiry of the previous units granted. This characteristic gives the phantom share scheme an indefinite life cycle until the point that the employer decides to terminate the scheme.

3.6 Forfeitable Share Plan

A forfeitable share incentive plan is share scheme whereby the employees are given equity shares in the employer for free at the inception of the share plan i.e. no purchase consideration. The equity shares delivered to the employees will be subject to certain provisions, which if not fulfilled, will result in the employee forfeiting the right to the equity shares.

These forfeiting criteria will commonly require the employee to remain in employment with the specified employee for a certain amount of time, with the possibility of containing specific other performance criteria. The employee, once granted the equity shares will hold the full rights to these shares, receiving dividends and entitlement to the capital growth of the equity shares.

The advantages of this form of share incentive plan are that the plan operates efficiently during both a bull and bear market, the imposition of performance criteria provide additional incentives for the employees, it assists in retaining quality employees who would lose the equity share incentive if the employee(s) were to leave the employer. The cons of such a scheme are that the external shareholder of the employer company would not be easily convinced of share value dilution due to the issuance of further equity shares, hence why the performance criteria conditions and criteria are key and need to be strictly administered and adhered to. If the performance conditions are too onerous, then this may serve as a disincentive to the employees and the number of shareholders increases substantially.

To avoid the complexities and administration issues surrounding the increased number of shareholders, a company may interpose a share trust between the employees and the equity shares. The added benefit to this structure is that a loan may be required in order for the trust to acquire the equity shares in the employer, which could provide the employer company with a tax deduction.

The employees will have to declare the receipt of the equity share(s) in their gross income in the period in which the employee becomes unconditionally entitled to such equity shares. The employer will in turn need to withhold PAYE in terms of the Fourth Schedule to the Act.

3.7 Conclusion

Share incentive plans has evolved rapidly over the years due to the changing landscape in terms of regulatory and taxation affairs. The lucrative taxation benefits previously enjoyed by employees have been quashed by the Revenue authorities and each of the above schemes needs to be carefully analyzed by the employer before implementing. Chapter four provides an

overview of the structure and arrangements employed in the PE industry to remunerate their employees that fall within the ambit of section 8C of the Act and how these arrangements derive their value. This provides an insight into the potential 'capital versus revenue' issues being experienced.

4 CHAPTER 4 – THE APPLICABILITY OF SECTION 8C TO THE PRIVATE EQUITY (“PE”) INDUSTRY

4.1 Introduction

The chapter seeks to provide a synopsis of the structures employed in the PE industry with emphasis on the fund manager or staff co-investment vehicle, the relationship between the fund and the fund manager co-investment vehicle with specific reference to how the value is derived and lastly, address how these investments in the staff co-investment vehicle fall within the ambit of section 8C of the Act. In addition, the potential for a catalytic change in nature of the income by the investors in the staff co-investment vehicle is discussed briefly.

4.2 Background

The South African PE industry is one of the most developed emerging markets around the world. The industry includes more than 110 fund management companies, all full members of the South African Venture Capital Association.³⁹ These firms include fund managers who raise third party funds and manage on-balance sheet investments for banks, insurance companies, investment holding companies or government development agencies.⁴⁰

It is submitted that within the PE industry there are two commonly used structures to house the investments for investors, one, being the limited liability partnership, otherwise known as the *En Commandite Partnership* and two being the *Bewind Trust*⁴¹. There are several compelling reasons for the use of these two structures, being, the income and capital gains earned within the structure are taxed within the hands of the partners or beneficiaries, the structures provide the investors with limited liability (explained in further depth below), the structures are not subject to cumbersome regulations and can be established or formed with relative ease, the day-to-day operations of these structures can be easily outsourced providing the fund

³⁹ See, <http://www.savca.co.za/membership/member-directory/member-list-and-contact-details/full-members/>

⁴⁰ See, page 202 of the Private Equity Review, Fifth Edition

⁴¹ See, Page 205 of the Private Equity Review, Fifth Edition

manager with a high degree of autonomy, and lastly, the contractual and organisational practices are akin to international standards.

It is submitted that an attorney will advise on the legality, validity and enforceability of the partnership agreement or trust deed. According to the Private Equity Review, Trust deeds and partnership agreements have largely been standardised over the years and will address many of the following issues:

- Minimum investment requirement for the fund manager, adviser or associate;
- Time periods for the making of investments and disinvestments by the fund;
- Guidelines, requirements and prohibitions relating to investments;
- The composition and functions of the investor advisory board;
- Conflicts of interest;
- Distributions (including whether distributions must be in cash and claw back provisions);
- Carried interest (in this regard, investors increasingly insist that the carried interest be calculated over the life of the fund and that distributions of carried interest be kept in escrow);
- Fees of the adviser or fund manager;
- Replacement of the fund manager;
- Limitations of liability for managers;
- Termination of the fund; and
- The use of side letters agreements; etc. ⁴²

In addition to the PE fund, the fund management company will structure a staff co-investment vehicle (whether in the form of a trust or a partnership) affording the advisors and fund managers to claim a stake in the investment, otherwise known as “their skin in the game”. The focus of this chapter will surround the staff or fund manager co-investment vehicle (labelled “A” in the diagram provided below). The two most prevalent structures used to create and administer the staff or fund manager co-investment vehicle are outlined below with the specific tax clauses and provisions applicable.

⁴² See, page 207 of the Private Equity Review, Fifth Edition

4.3 Structure of Co-Investment Vehicle

The structure under which the staff co-investment vehicle operates is either through the *En Commandite Partnership* or a *Bewind Trust*. It is submitted that it is common practice for a trust to be structured to house the fund manager or co-advisor's investment in the fund to avoid the need or creation of a general partner, which would be housed in a company. Each structure is discussed in detail below for the sake of clarity.

4.3.1 *En Commandite Partnership*

The *En Commandite Partnership* (herein referred to as 'the Partnership') is a commonly used structure for investment funds. It is established by way of a contract between the general partner or disclosed partner (referred to as 'the GP') and the limited partners. The Act does not define what constitutes a 'partnership' but it is important to establish how the Act defines a 'limited partner'. Section 24H of the Act ascribes the following meaning:

"any member of a partnership *En Commandite*, an anonymous partnership, any similar partnership or a foreign partnership, if such member's liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited."⁴³

Based on the above definition, for one to meet the definition of a limited partner the liability towards the Partnership of such person needs to be limited. The limited partners will contractually commit a fixed sum of money (there may future contributions – as is commonly seen in the PE industry), which affords them a certain share of the profits and losses. Conversely, in the event of losses being incurred by the Partnership, the limited partners can only lose as much as they have contributed to the Partnership. In scenarios where the Partnership begins to use derivatives or enters into lending arrangements (otherwise known as short selling), the provisions surrounding limited liability become of grave importance. The

⁴³ See, section 24H(1) of the Act

engagement into transactions of this nature, commercially involves the use of leverage which could mean that more than the committed capital of the Partnership could be lost to creditors.

Within the Partnership agreement, it will contain commercial clauses and provisions detailing the following elements:

- The limited partners may not actively participate in the business of the partnership;
- Profit sharing arrangements;
- Permitted expenses (which should be read or drafted in conjunction with section 11(a) of the Act); and
- Investment restrictions.

In event that the Partnership sustains losses greater than its net asset value⁴⁴, the GP will cover the losses sustained past the point of the net asset value. It is submitted that the GP has unlimited liability to the creditors of the Partnership. The question arises of what would occur in a scenario where the GP is unable to service the excessive debts of the Partnership and the limited partners contribute to the servicing of such debt. This question is addressed below.

4.3.1.1 Tax Implications of the Partnership

A Partnership is viewed as fiscally transparent entity in which all income, expenditure and gains and losses flows directly through to the underlying limited partners. These limited partners are viewed in terms of section 24H (2) of the Act to have each conducted the trade or business that the Partnership carries on⁴⁵.

Although this is contrary to the premise established above, whereby the limited partners are removed from the day-to-day to operations of the Partnership by the provisions agreed to in the partnership agreement, this provides the Commissioner of SARS with a mechanism of assessing the income, expenditure, gains and losses flowing to the underlying partners.

⁴⁴ The net asset value is equal to the market value of all assets less the market value of liabilities.

⁴⁵ See, section 24H (2) of the Act

Should these provisions not exist, the Partnership would become a taxable entity due to the definition of 'trade' in section 1 of the Act. In terms of permissible deductions, the limited partners are prohibited from claiming deductible expenditure⁴⁶ in excess of the following –

- Their contribution to the partnership;
- An amount for which the limited partner will be held liable to by a creditor of the partnership; and
- The amount of income received or accrued by the limited partner from the partnership⁴⁷.

Should there be an excess of deductible expenditure against the three above mentioned benchmarks, the limited partner will be afforded the right to carry the excess amount into the following assessable tax period⁴⁸.

The last provision of section 24H of the Act governs the appropriate split in the income, deductions and allowances. In terms of paragraph 5(a) and (b) of section 24H, the income and permissible deductions are deemed to be accrued or received for the benefit of the underlying limited partners in proportion to their profit-sharing ratio. The profit-sharing ratio must be applied in accordance with the relevant agreement, the partnership agreement. The amount of income and permissible deductions allocated to the limited partners will then form part of their taxable income in the relevant year of assessment.

On a technical basis, every time a limited partner acquires an interest or disposes of their interest in the Partnership, there is a realisation of unrealised gains and losses as each limited partners' share in profits and losses have changed. The realisation of these gains and losses will create a tax event for the remaining and departing partners. Depending on the provisions and clauses provided for in the Partnership agreement, the entry and exit of new and existing limited partners may require the dissolution or termination of the current Partnership and

⁴⁶ Provided the expenditure meets the necessary requirements of section 11(a) of the Act, which can be summarised as follows:

- The expenditure must be actually incurred by the taxpayer;
- The expenditure must be incurred in the production of income; and
- The expenditure must not be of a capital nature.

⁴⁷ See, section 24H (3) of the Act

⁴⁸ See, section 24H (4) of the Act

continuation of a new Partnership. In practice, it is submitted that these scenarios have been catered for in a standard PE Partnership to ensure continuity and minimal distraction to the operation of the Partnership.

The important question to be answered is how much of a tax deduction, the limited partners could claim should they service the debt of the Partnership greater than the Partnerships current net asset value. In ITC 328⁴⁹, the court ruled that the partners' losses deductible were limited to the amount as represented by the Partnership agreement and that the losses incurred due to the other partner was a loss of a capital nature. These issues have been covered by the pertinent parties through the necessary due diligence and assurance of resource backing for the GP.

Based on the above evidence, it is submitted that each limited partner is deemed to have carried on the trade or business of the partnership based on the provisions within section 24H of the Act and through the definition of 'trade' in section 1 of the Act. And all income, permissible deductions and allowances must be proportionately allocated to each limited partner.

4.3.2 Bewind Trust

The *Bewind Trust* (herein referred to as 'the Trust') is established through the conclusion of a trust deed which is ratified by the Masters of the High Court and regulated by the Trust Act⁵⁰. The Masters court has limited regulatory power of the trust but may for instance, apply to the court for the removal of a trustee.

The Trust differs slightly from other forms of trust in the South African context. The trustees of the Trust do not have beneficial ownership over assets but merely hold and administer the assets on behalf of and for the beneficiaries. The Act views a 'trust' as a "trust fund consisting

⁴⁹ Income Tax Case No. 328 (1935) 8 SATC 258

⁵⁰ Trust Property Control Act, No. 57 of 1988

of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust...”⁵¹.

A beneficiary is defined in section 1 of the Act as “a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust.”⁵² A notable distinction, is the difference in rights a beneficiary can hold in terms of a trust. The act does not define the two kinds of rights a beneficiary can hold but in Jewish Colonial Trust⁵³ case, Watermeyer JA described a ‘vested right’ as:

“Unfortunately, the word “vest” bears different meanings according to its context. When it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right – that he has all rights of ownership in such right including the right of enjoyment.”⁵⁴

The second right available to beneficiaries is a ‘conditional right’ which can be ascribed the meaning of a right that is contingent on the happening of some fixed or variable future event. It is submitted that the investors within the Trust will all constitute beneficiaries in terms of the Act and will have a vested right to all income and capital accumulated in the Trust. This is in terms of the provisions within the trust deed.

4.3.2.1 Tax Implications of the Trust

Trusts are governed under section 25B of the Act, subject to section 7 of the Act. This means, where section 7 of the Act applies, it will override the principles in section 25B of the Act. Section 25B (1) of the Act speaks to the allocation of income and with specific reference to the scenario where a beneficiary has a vested right to any amount, said amount will accrue to the beneficiary and conversely, if not accrued to the beneficiary it will accrue to the trust.

⁵¹ See, section 1 of the Act

⁵² See, section 1 of the Act

⁵³ Jewish Colonial Trust Ltd vs Estate Nathan 1940 AD 163

⁵⁴ See, page 175 – 176 of Jewish Colonial Trust Ltd vs Estate Nathan 1940 AD 163

As established above, the trust deed will contain provisions deeming all beneficiaries to have a vested right. It is submitted that tax planners and advisors will mitigate the amount accruing to the Trust, as a trust is taxed a flat rate of forty-one percent versus the sliding scale an individual is subject to. Should an amount accrue to the Trust, the trustee(s) within the pertinent ambit of the trust deed can apply discretion to the vesting of income in the hands of all or some of the beneficiaries⁵⁵.

Under section 25B (3), any deduction or allowance granted within the relevant provisions of the Act will be deemed to be a deduction or allowance in the hands of the beneficiaries should they hold a vested right. As is the case for partnership, any amount by which the permissible deduction or allowances exceed the income included in taxable income by the beneficiary must be disregarded for that year of assessment⁵⁶. The passage of law prevents the potential for losses to be set off in the hands of the beneficiaries.

The excess amount of permissible deductions and allowances is treated slightly different in terms of a trust. The excess or non-deductible portion computed in the hands of the beneficiaries is reverted back to the trust and can be used for set-off against the trust income, provided the trust has income⁵⁷. If the trust has no income, then the shortfall of deductions and allowances is granted for set off in future taxable periods for the benefit of the beneficiaries⁵⁸. Should the beneficiary not be a resident in terms of the Act, then the provisions of section 25B (4), (5) and (6) do not apply and no excess permissible deductions or allowances can be used for future set-off. Within the private equity industry, the Trust will not have income for which to offset the deductions or allowances and therefore, no deductions or allowances will be allowed for set off.

With the recent introduction of section 7C into the Act, the operators of a trust need to ensure that all transaction involving a loan, advance or credit in some form should ensure that the official rate of interest is charged. Should this not occur, in terms of section 7C (3) of the Act,

⁵⁵ See, section 25B(2) of the Act

⁵⁶ See, section 25B(3) and (4) of the Act

⁵⁷ See, section 25B(5) of the Act

⁵⁸ See, section 25B(5) of the Act

the differential between the official rate of interest and the actual rate of interest charged will constitute a deemed donation in the hands of the borrower⁵⁹.

4.4 Operations of the Private Equity Fund

The PE fund (herein referred to as ‘the Fund’) would generally appoint the fund manager and co-advisors to the Fund in terms of a written mandate, which will govern the underlying investments that may be researched and acquired. The fund manager and co-advisors would ensure all day-to-day operations of the Fund are seen to, which would include identifying and executing investments and disinvestments into and from various assets. The fund manager would not have direct contractual obligations with the underlying investors in the Fund (save for sake in the case of a side letter agreement⁶⁰ being constituted), but purely with the Fund itself. It is submitted that the use of side letter agreement between the general partner and a single or group of limited partner(s) / beneficiary (ries) will need to be documented in the partnership agreement.

It is submitted that over the years and potentially due to rigorous development in disclosure and regulation and substantial inclusion of institutional investors into the alternative investment market, there has been growing need for the use of an independent valuator or administrator. The services of the independent valuator will typically include cash management, fund accounting and record keeping, statutory tax reporting and investor reporting.

Investors would commit to the fund by signing a deed of adherence to the partnership agreement or the trust deed. The salient details of the Fund will be disclosed to the prospective investor via the short-form private placement memorandum. The Fund in theory could satisfy the requirements of a collective investment scheme, governed under the

⁵⁹ See, section 7C of the Act

⁶⁰ As quoted by Ice Miller Legal Counsel in “The use of side letter agreements in Private Equity Investments”:

“Side letter agreements have long held a place in the private equity fund investment world as they have regularly been used as a means of interpreting, supplementing and even altering the terms contained in partnership agreements and other governing documents. The historical use of side letter agreements has been somewhat limited to addressing special arrangements with certain investors (e.g. seed or early close investors) and/or unique issues that are specific to only a particular investor or subset of investors (e.g. governmental pension plans);”.

CISCA⁶¹, if 'members of the public'⁶² are invited and permitted to invest. Currently, under the CISCA there is no licensing scheme available to regulate PE funds. For this reason, it is not advisable for PE firms to advertise or market their funds in the press. Another form of mitigating the provisions of the CISCA is the limitation of the number of limited partners or beneficiaries.

The underlying assets purchased by the PE Fund could include any of the following:

- Equity shares;
- Preference Share Funding;
- Debentures;
- Loan Funding – in the form of Bonds or Notes; etc.

4.5 The Staff Co-Investment Vehicle

As many employers initiate and employ across the world, the PE industry follows suite and concludes certain arrangements with certain staff members, more specifically the fund managers or co-advisors of the Fund for the purposes of 'locking' these staff members in. The reasons for this, are to ensure the PE fund management companies' financial interest are aligned with that of the fund manager or co-advisors of the Fund, reduce the turnover of staff, which if not managed appropriately can have detrimental effects on the performance of the Fund and the reputation of the PE fund management company.

The arrangements are packaged in the form of a beneficial or partnership interest in the staff co-investment trust or partnership, with the fund manager or co-advisor paying a specific purchase price upon entry into the staff co-investment fund (used as reference to use of either the *Bewind Trust* or the *En Commandite Partnership*). The arrangement or share of the Fund

⁶¹ The Collective Investment Schemes Control Act, No. 45 of 2002

⁶² In terms of the CISCA, 'members of the public' include –

“(a) members of any section of the public, whether selected as clients, members, shareholders, employees or ex-employees of the person issuing an invitation to acquire a participatory interest in a portfolio; and

(b) a financial institution regulated by any law,

but excludes persons confined to a restricted circle of individuals with a common interest who receive the invitation in circumstances which can properly be regarded as a domestic or private business venture between those persons and the person issuing the invitation;”

would fall within the part of the definition of an ‘equity instrument’, as described in section 8C (7) of the Act:

“any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member’s interest;”⁶³

It is submitted that within these arrangements, there are numerous clauses that effectively deem the beneficial or partnership interest in this vehicle to be a restricted equity instrument. The clauses mentioned above would fall under the following parts of the definition of a ‘restricted equity instrument’ within section 8C (7) of the Act:

- “(a) which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;
- (b) which is subject to any restriction that could result in the taxpayer—
 - (i) forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or
 - (ii) being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;”⁶⁴

It has been established that the beneficial interest in the staff co-investment vehicle held by co-advisors or fund managers will firstly constitute an ‘equity share’ and secondly, a ‘restricted equity instrument’ as defined in section 8C of the Act, provided the pertinent restrictions were imposed on the partnership or beneficial interest held by the fund manager or co-advisors in the staff co-investment vehicle.

4.5.1 The value derived by the Staff Co-Investment Vehicle

The staff co-investment vehicle will serve as the initial gateway for the fund manager or co-advisors exposure to the underlying assets of the Fund. The staff co-investment fund will hold

⁶³ See, section 8C(7) of the Act

⁶⁴ See, section 8C(7) of the Act

a beneficial or partnership interest in the Fund from which the value of the fund manager or co-advisors beneficial interest will derive a value.

The Fund will increase or decrease in value due to the change in value of the underlying assets it holds which will come in various forms. Firstly, dividend income, which will be exempt⁶⁵ from normal income tax (subject to certain exceptions in respect of preference share funding or lending arrangements). The Act deems certain dividends on shares that contain debt-like characteristics to be income in the hands of the investor. The rules pertaining to such arrangements are contained within section 8E and 8EA of the Act. In the hands of an individual, the dividends will be subject to dividends withholding tax ('DWT') at a rate of twenty percent⁶⁶. Secondly, interest income will be earned by the fund through any investment into debt instruments, through the granting of loans to underlying investee companies and on any additional cash and cash equivalents invested with banking institutions. Interest will be subject to normal income tax in the hands of an individual, subject to the annual exemptions of R 23 800.00⁶⁷ allowed. Investor dependent, the interest income may be subject to interest withholding tax dependent on the source of the underlying interest and the domicile of the investor⁶⁸.

It is submitted that the primary drivers of an increase in the value of the Fund will be the unrealised or realised gains made through the investments into preference shares or standard equity shares. The investments and their point of realisation will generally be long after the opening or establishment of the Fund. Typically, it is submitted that PE investments have a longer realisation period than the standard investment into instruments listed on a recognised exchange.

It is submitted, that it is common practice for the Fund to have a prescribed lifetime, and upon reaching the date of closure will begin to wind down. The winding down of the Fund will constitute realising all existing investments, potential distribution of any unrealised assets and

⁶⁵ In terms of section 10(1)(k) of the Act

⁶⁶ The rate of DWT was increased from 15% to 20% on the 22nd of February 2017 by National Treasury. The amended rate became effective for all dividends paid on or after the 22nd of February 2017.

⁶⁷ Provided the person is below the age of 65. If the person is above the age of 65, further exemptions are applied.

⁶⁸ See, section 50A to 50H of the Act

profits and losses and the computation and payout of the carried interest, in terms of the provisions laid out in the partnership agreement or trust deed.

4.5.2 Comparison between the Staff Co-Investment Vehicle and a Share Incentive Plan

The staff co-investment vehicle draws similarities from three of the most prevalent share incentive plans, being the phantom share plan, forfeitable share plan and the share purchase plan.

The common premises adapted and used in the structuring of the staff co-investment vehicle are as follows:

- The use of a loan from the PE fund management company to the staff co-investment vehicle for the fund managers and co-advisors to purchase an indirect stake in the Fund
 - The indirect investment into the Fund may be facilitated in two manners:
 - The staff co-investment vehicle purchases an interest in the Fund directly
 - The staff co-investment vehicle purchases equity shares from the General Partner
- The fund managers and co-advisors purchase an interest in the staff co-investment through direct settlement of the purchase consideration
- The employer may place performance criteria on the interests acquired in the staff co-investment vehicle
 - It is submitted that this would be more prevalent in the scenario where a loan is provided to the staff co-investment vehicle and the fund managers and co-advisors receive their interests for no consideration

Although the reasons and considerations for imposing restrictions on the interests held in the staff co-investment vehicle are distinctive to that of a vanilla share incentive plan, certain traits are consistent.

4.6 Case Studies

The two case studies below illustrate and highlight the flaws in the current legislation and its applicability to the PE industry, which does not cater for the more aggressive tax planners.

4.6.1 Facts for Both Case Studies

A PE fund (“the Fund”) is established through the structuring of an En Commandite Partnership. The General partner is appointed and other investors, being Limited Partners contribute cash to the Fund. The General Partner will contribute less than the Limited Partners due to the risk taken on, which was explained above.

In addition to the Fund, the PE fund management company establishes a staff co-investment trust (“the Trust”). The fund managers and co-advisors of the Fund make capital contribution to the Trust to align their financial interests with that of the PE firm and the underlying Limited Partners in the Fund.

The beneficial interests in the Trust are issued to fund managers and co-advisors with the following restrictions imposed on them:

- The beneficial interest may not be disposed of for first three-years of existence of the Fund
- Post the initial three-year period, fifty percent of the beneficial interest may be disposed
- The remaining fifty percent of the beneficial interest may only be disposed in three tranches (one tranche per year – as per below) provided the Fund has generated annualised return of twenty percent or more
 - o Tranche 1: Ten percent
 - o Tranche 2: Ten percent
 - o Tranche 3: Thirty percent
 - o If the performance condition is not fulfilled, the beneficial interest will be available for disposal at the winding up of the Fund

4.6.1.1 Structure for Case Study One

The Trust would in turn make a capital contribution to the Fund and hold a partnership interest on behalf of the fund managers and co-advisors. Based on the structure employed to facilitate the investment into the Fund by the Trust, the amounts accrued or received from the underlying assets in the Fund would flow through to the ultimate beneficial owner of the interest in the Trust (refer to Diagram One below).

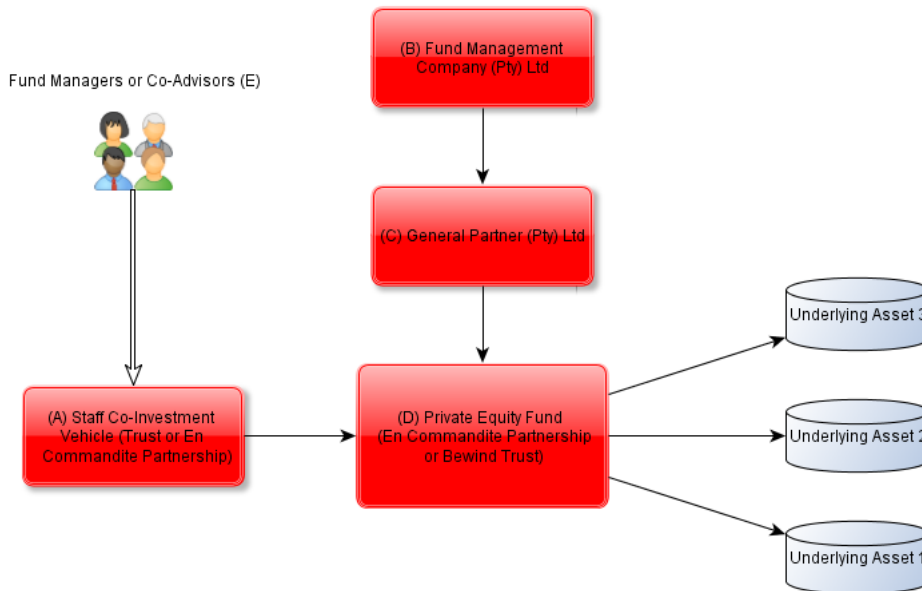
4.6.1.2 Structure for Case Study Two

With the capital contributions received from the fund managers and co-advisors, the Trust will acquire a specified number of equity shares in the General Partner (refer to Diagram Two below). The specified class of shares acquired from the General Partner will have the above restrictions imposed.

There is evidently a causal link between the employees (being the fund managers and co-advisors) as the Trust and General Partner would be classified as an associated institution of the employer (being the PE fund management company). Based on the above restrictions imposed and the causal link established, the beneficial or partnership interests and equity shares issued would be classed as restricted equity instruments in terms of section 8C of the Act. It is anticipated that the Fund would have a life expectancy of eight years after which all the underlining assets would be disposed of and the limited partners and general partner would disinvest from the Fund.

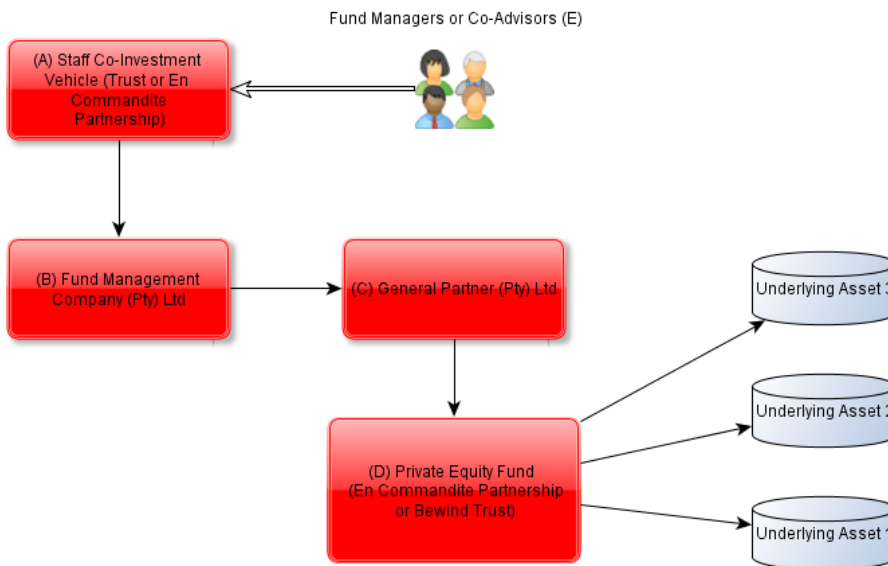
4.6.2 Diagram One⁶⁹

The below diagram illustrates the structure and relationship of all parties described above. It is submitted that the below structure would be considered a standard PE structure.



4.6.3 Diagram Two

The below diagram illustrates the structure and relationship of all parties described above. It is submitted that the below structure would be considered a standard PE structure.



⁶⁹ Note: this diagram was recreated from a presentation given by the South African Venture Capital Association (SAVCA).

4.6.4 Tax Considerations

The following are the general tax principles that would flow during the existence of the Fund. However, the focus of this case study is rather on the tax consequences on the vesting of the beneficial interest and equity shares in the Trusts and General Partner, in the hands of the fund managers and co-advisors and the subsequent disposals of these beneficial interests or equity shares.

4.6.4.1 General

The capital contributions received by the Fund, for which a partnership interest will be issued to the General and Limited Partners, will not trigger a tax event. These contributions will establish the base costs or expenditure (where relevant) for the partners in question.

The Fund would deploy the capital contributions received into varying underlying instruments. For the sake of completeness, the Fund would accrue and incur the following items:

The Fund will earn dividends on the equity shares, upon which DWT will be levied at a rate of twenty percent and dependent on the nature of the underlying beneficial owner I.e. the beneficial owner could a company be subject to an exemption under section 64F of the Act. For diagram two, the picture is different in that the dividends earned from the Fund will be exempt from DWT under section 64F (1)(a) of the Act, and DWT will only be levied when the General Partner declares a dividend to its underlying shareholders, being the fund managers and co-advisors.

Any dividends accrued or received on preference shares will constitute income in the hands of the fund managers and co-advisors. Therefore, these dividends will be exempt from dividend withholding tax ('DWT') under section 64F (1)(l) of the Act. The definition of a 'preference share' as per section 8EA of the Act is as follows:

"...

(a) Other than an equity share; or

(b) That is an equity share, if an amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money;⁷⁰

In addition to the preference shares held by the Fund falling within the definition provided above, the preference share must constitute a 'third party backed-share', which is defined as in section 8EA (1) of the Act as being:

"Any preference share or equity instrument in respect of which an enforcement right is exercisable by the holder of that preference share or equity instrument or an enforcement obligation is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share or equity instrument not being received by or accruing to any person entitled thereto."⁷¹

Due to there being an enforceable right⁷² attached to the preference shares, which is a specified amount of a dividend each year. Due to this classification of the preference shares, the provisions of section 8EA (2) of the Act apply, and the dividends accrued or received on these instruments will constitute income in the hands of the underlying investors.

The amount of interest accrued and / or received on debt-based instruments acquired and / or loans granted to underlying investment companies by the Fund, will be accounted for and disclosed in the annual financial statements of the Fund in terms of section 24J of Act. In Diagram One, the flow through principles are applied and the total interest earned by each of the fund managers and co-advisors will be subject to normal income tax in the applicable year of accrual. In Diagram Two, the General Partner will subject to normal income tax on the total interest earned.

⁷⁰ See, Section 8E of the Act

⁷¹ See, Section 8EA(1) of the Act

⁷² An 'enforceable right' is defined in section 8EA of the Act as:

"in relation to a share or equity instrument means any right, whether fixed or contingent, of the holder of that share or equity instrument or of any person that is a connected person in relation to that holder to require any person other than the issuer of that share or equity instrument to—

(a) Acquire that share or equity instrument from the holder;

(b) Make any payment in respect of that share or equity instrument in terms of a guarantee, indemnity or similar arrangement; or

(c) Procure, facilitate or assist with any acquisition contemplated in paragraph (a) or the making of any payment contemplated in paragraph (b);"

The expenditure accrued and incurred by the Fund will be subject to the rule contained in section 11(a) and section 23 of the Act. In terms of section 11 (1)(a) of the Act, for the expenditure to be deductible from taxable income, the following requirements need to be met:

“(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

- a) Expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;”⁷³

To summarise the four requirements to be met for expenditure to be deductible are as follows:

- The person (or the Fund) must be carrying on a trade (as defined in section 1 of the Act);
- The expenditure or loss must be incurred by the person;
- The expenditure or loss must be linked to the production of income; and
- The expenditure or loss must not be of a capital nature.

Provided the above four requirements have been met, the amounts accrued and incurred by the Fund be deductible in the hands of the General and Limited Partners in terms of section 11 of the Act.

If the Fund realises gain and losses on the disposal of underlying investments, these amounts would be subject to normal income tax or CGT based on the underlying nature of the investments. Several factors will have to be considered to determine whether the underlying investments have been acquired on capital or income account. The underlying instrument will be examined, the intention with which the asset was acquired and the frequency of trades⁷⁴. Section 9C of the Act does provide for the gain or loss on equity shares to be taxed as capital in nature, provided the asset has been held for a continuous period of three years. It is commonly understood and submitted that the Fund will take a long-term view on an investment acquired in any underlying company, and this investment will be held through the lifespan of

⁷³ See, section 11 (1)(a) of the Act

⁷⁴ This list of factors considered is not exhaustive and will be considered with the facts of each case.

the Fund. This will result in the realised gains or losses on the disposal of underlying investments being subject to CGT.

4.6.4.2 Vesting of Beneficial Interest / Equity Shares

As discussed under in Chapter Two, vesting is the event that triggers a tax event and effectively a person becomes liable for tax on the gain or loss made since the acquisition of the specified equity instrument. The vesting of the equity instrument will occur on the earliest of the following events:

- Once the last restriction is lifted / fulfilled;
- Immediately prior to a taxpayer disposing of the restricted equity instrument;
- When the equity instrument terminates when it is still an option or a financial instrument;
- Immediately before a taxpayers' death, if all the restrictions relating to the equity instrument are or may be lifted on or after death; and
- Disposals as contemplated in section 8C (2)(a)(i) and 8C (2)(b)(i) of the Act, which are disposals back to the employer (or associated institution or other person) by arrangement for an amount that is less than market value.

The vesting of the beneficial interest or equity shares in tranches is consistent with that of a share option scheme, whereby an employer offers an employee the opportunity to exercise the options in stages. The partial vesting of such instruments was discussed in the Bosch⁷⁵ case.

Once the end of the three year-period is reached, the first restriction is fulfilled and met, and the fund managers and co-advisors are permitted to dispose of fifty percent of their beneficial interest in the Trusts or equity shares in the General Partner. At this point regardless of whether the parties dispose of their beneficial interests or equity shares, fifty percent of their beneficial interest or equity shares would vest in terms section 8C of the Act. The gain or loss

⁷⁵ See, Commissioner SARS v Bosch (394/2013) [2014] ZASCA 171 (19 November 2014)

(the difference between the market value and the cost of acquisition) must be determined at the date of vesting upon which normal income tax will be levied.

Post the initial three-year period, the annualized return of the Fund will need to be assessed to determine whether the first tranche has vested in the hands of the beneficial owner. This will need to be completed on annual basis until the point at which the Fund is wound up. At the end of each of the measurement periods, provided the performance criteria has been met, the increase in market value will be subject to normal income tax in the hands of the fund managers and co-advisors.

The situation for the holders of equity shares in the General Partner is that, post a vesting date, the gain or loss declared under section 8C of the Act will form part of the base cost for CGT purposes in addition to the amount of purchase consideration. This is confirmed by paragraph 20(1)(h)(i) of the Eighth Schedule to the Act which states the following:

“(h) In the case of –

(i) A marketable security or an equity instrument, the acquisition or vesting, as the case may be, of which resulted in the determination of any gain or loss to be included in or deducted from any person’s income in terms of section 8A or 8C the market value of that marketable security or equity instrument that was taken into account in determining the amount of that gain or loss (including where the gain and loss so determined was nil);”⁷⁶

In the past, a company may have declared a corporate action or distribution in some form to dilute the value of the equity shares, which in effect lowers the amount of income tax payable on the gain or loss upon vesting. This loop hole has been closed in the recent amendments (discussed in Chapter Two), which includes any amount that is received by the holder in relation to a restricted equity instrument.

⁷⁶ See, Paragraph 20(1)(h)(i) of the Eighth Schedule to the Act

The wording of section 8C (3)(b)(i) of the Act (shown below – bolded words), could be interpreted to mean that all of the restrictions need to be fulfilled prior to any form of vesting occurring. The vesting of the beneficial interest or equity shares in tranches is confirmed through Binding Class Ruling No. 25⁷⁷, which entails the vesting of share options at sequential periods post the initial allocation.

“An equity instrument acquired by a taxpayer is deemed for the purposes of this section to vest in that taxpayer—

(b) In the case of the acquisition of a restricted equity instrument, at the earliest of—

(i) When all the restrictions, which result in that equity instrument being a restricted equity instrument, **cease to have effect**,”⁷⁸

Finally, if the performance criteria are not met throughout the existence of the Fund since the initial three-year period, at the time of winding up the Fund the beneficial interest and equity shares will vest and the provisions of section 8C of the Act will apply.

4.7 Potential Injustice

The controversial issue at hand in the PE industry is whether from a tax perspective these arrangements, concluded between the fund managers and the co-advisors should fall within the ambit of section 8C of the Act. It is submitted that the underlying premise of section 8C of the Act, is to prevent an employer from converting what is an amount of income in nature to capital in nature.

It has been established above that based on the time period with which the Fund holds the underlying investments and the ultimate intention with which those investments were acquired, a large share of the increase in the market value of the partnership interest in the En Commandite Partnership or the beneficial interest in the Bewind Trust is derived from amounts that would be treated as capital in nature.

⁷⁷ See, Binding Class Ruling No. 25, issued by SARS on 25 January 2011

⁷⁸ See, section 8C (3)(b)(i) of the Act.

To ascertain whether the disposal of an asset in the Fund will be capital in nature, the intention with which those assets were acquired and disposed of needs to be interrogated. This is discussed below.

4.7.1 Intention of the Investments

Although the Act provides safe harbour rules in the form of section 9C of the Act, whereby the disposal of an equity share is deemed capital in nature provided the holding period is greater than three years. The precedent set through case law still requires the intention, otherwise known as the taxpayer's *ipse dixit*, of the underlying equity share or asset holder to be determined and scrutinized.

In terms of section 102 of the Act, the onus lies with the taxpayer to prove his or her intention, of which the following will be considered by the courts:

- Length of time period with the assets has been held;
- Frequency;
 - An asset that is regularly bought and sold by the taxpayer will be viewed as income in nature.
 - In the Stephan⁷⁹ case, this factor did not aid the taxpayer who demonstrated lack of frequency, but his ultimate intention represented that of a profit-making scheme.
- Nature of the taxpayer's business;
 - In the Trust Bank of Africa Ltd⁸⁰ case, the taxpayer was required to satisfy the court that the disposal of certain equity shares was outside of its normal operating activities.
- Income stream of the asset(s);
- Reasons for and methods of disposal;
 - The taxpayer will need assure the courts that the sale and method of disposal did not refute the stated intention.

⁷⁹ Stephan vs Commissioner for Inland Revenue (1919 WLD 1), 32 SATC 54

⁸⁰ Trust Bank of Africa Ltd vs SIR (1975 (2) SA 652 (A)), 43 SATC 118

- Financing arrangements used for the acquisition of the asset(s); and
- Nature of the asset(s).

It should be noted that the factors listed above will not be conclusive evidence of the taxpayers underlying intention. All the factors will be considered with the relevant facts of the case at hand. It is submitted, that due to the time period with which a PE fund will commonly hold its investment in an underlying company, the gains or losses upon disposal will be capital in nature. For the purposes of the below example, all realised gains and losses are deemed capital in nature.

4.7.2 Example

The purpose of this example is to demonstrate the differential in taxes payable by a fund manager or co-advisor who has acquired a beneficial interest in any staff co-investment vehicle. For simplicity, the beneficial interest will be subject to non-disposal period of five years.

Profit and Loss for Five-Year Period – ending 28 February 2017

PROFIT AND LOSS STATEMENT - FUND MANAGER'S PROPORTIONATE SHARE OF THE FUND'S PROFIT AND LOSS					
	Year 1 - 28/02/2013	Year 2 - 28/02/2014	Year 3 - 28/02/2015	Year 4 - 28/02/2016	Year 5 - 28/02/2017
INCOME					
Local Dividends - Equity Shares *	236 589.00	272 077.35	312 888.95	359 822.30	413 795.64
Local Dividends - Pref. Shares *	152 300.00	152 300.00	152 300.00	152 300.00	152 300.00
Interest - Loans	115 000.00	265 000.00	288 850.00	314 846.50	343 182.69
Interest - Bonds	258 697.00	271 631.85	285 213.44	299 474.11	314 447.82
EXPENSES					
Audit Fees	(100 000.00)	(110 000.00)	(121 000.00)	(133 100.00)	(146 410.00)
Administration Fees	(250 000.00)	(265 000.00)	(280 900.00)	(297 754.00)	(315 619.24)
Dividends Withholding Tax	(35 488.35)	(40 811.60)	(46 933.34)	(53 973.34)	(82 759.13)
REALISED AND UNREALISED GAINS/(LOSSES)					
Realised - Portfolio Companies **	0.00	0.00	0.00	5 242 123.00	14 141 930.00
Unrealised - Portfolio Companies	1 456 789.00	1 897 562.00	2 846 343.00	1 527 895.00	0.00
	1 833 886.65	2 442 759.60	3 436 762.05	7 411 633.57	14 820 867.78
* The dividends received on preference share and normal equity shares will constitute income in the hands of the investor and is therefore, exempt from DWT under section 64F(l) of the Act.					
** This pertains to realised investments on equity shares held for a period of greater than three years. Thus, section 9C will apply.					

Market Value Summary for Five-Year Period – ending 28 February 2017

SUMMARY OF MARKET VALUE - SHARE OF THE PARTNERSHIP					
Opening Balance	5,000,000.00	6,833,886.65	9,276,646.25	12,713,408.30	20,125,041.87
Increase/(Decrease) in Market value	1,833,886.65	2,442,759.60	3,436,762.05	7,411,633.57	14,820,867.78
Closing Balance	6,833,886.65	9,276,646.25	12,713,408.30	20,125,041.87	34,945,909.64

Tax Computation for Five-Year Period – ending 28 February 2017⁸¹

TAX COMPUTATION - FUND MANAGER*					
* If the beneficial interest held by the fund manager was not subject to section 8C of the Act					
TOTAL P&L - YEAR UNDER ASSESSMENT	1 833 886,65	2 442 759,60	3 436 762,05	7 411 633,57	14 820 867,78
ADJUSTMENTS:					
Unrealised - Portfolio Companies	(1 456 789,00)	(1 897 562,00)	(2 846 343,00)	(1 527 895,00)	0,00
Local Dividends - Equity Shares *	(236 589,00)	(272 077,35)	(312 888,95)	(359 822,30)	(413 795,64)
Dividends Withholding Tax	35 488,35	40 811,60	46 933,34	53 973,34	82 759,13
Realised - Portfolio Companies **	0,00	0,00	0,00	(5 242 123,00)	(14 141 930,00)
CAPITAL GAINS TAX INCLUSION					
Realised - Portfolio Companies **	-	-	-	1 737 200,60	5 644 772,00
TAXABLE INCOME - YEAR UNDER ASSESSMENT	175 997,00	313 931,85	324 463,44	2 072 967,21	5 992 673,27
TAXES DUE	32 407,25	69 650,56	71 486,03	770 970,56	2 376 427,04
TOTAL TAXES DUE OVER FIVE YEAR PERIOD	3 320 941,43				

Tax Computation at the Date of vesting of the Beneficial Interest – ending 28 February 2017

TAX COMPUTATION - VESTING OF BENEFICIAL INTEREST					
Purchase Consideration					5 000 000,00
Market Value at date of Vesting					34 945 909,64
Gain at date of Vesting					29 945 909,64
Tax Liability:					
Fixed Portion					206 964,00
Variable Portion					11 990 289,95
					12 197 253,95

The differential in taxes due between the two scenarios is vast and considering the reasons for restricting the beneficial interest or equity shares in the PE industry, demonstrates a clear disparity. The commercial reasons for the imposition of restrictions are discussed further below.

⁸¹ This computation represents the amounts of taxes due if no restrictions had been placed on the beneficial interest held by the individual.

4.8 Commercially – should these arrangements fall within the ambit of Section 8C

Based on the underlying intentions of imposing restrictions on the fund managers and co-advisor's investments into the staff co-investment vehicle, it is submitted that section 8C of the Act imposes counterintuitive implications for the PE industry for the following reasons.

A fundamental principle in many organisations is that staff members should take control of their financial performance and assume accountability for that performance. The employees should be viewed by the legislature in the same light as external independent shareholders. The intention of imposing restrictions is not to create a salary conversion plan, but financial remunerate employees in a manner more consistent with their actual performance and value add.

The overall objectives of defining restrictions on arrangements such as these is, firstly, to encourage ownership by the staff members of the PE Fund Management company. Secondly, the fund managers and co-advisor's financial interests are aligned with that of the PE Fund management company and the external investors of the Fund. The PE Fund management company is assured that the fund managers and co-advisors remain committed to the long-term initiatives of the firm. Although, the intentions stated above will be akin to that of a standard share incentive scheme implemented by any other corporate employer. The underlying assets of the Fund from which the beneficial interest(s) or equity share(s) derive their value is vastly different to that of the share incentive scheme implemented by any other corporate employer.

Due to the length of time with which PE funds take to realise an investment in an underlying company, it is imperative that the fund management firm and the fund managers and co-advisors are aligned in terms of the long-term strategies of the Fund and the firm. As demonstrated above, majority of value assigned to the beneficial interest or equity shares derived off the back of items that would be considered capital in nature. In principle, section 8C of the Act creates adverse effects for the PE industry by converting what are amounts of a capital in nature to income in nature.

4.9 Conclusion

Regardless of the structure employed for the creation of the staff co-investment vehicle, the ultimate result for the fund managers and co-advisors remains the same. The underlying instruments held by the Fund due to the time period with which they are held (which is driven by the life expectancy of the Fund), the intention with which these investments are purchased and disposed of – will be considered capital in nature and subject to section 9C (instrument type dependent) and Schedule 8 to the Act.

Due to the operations of the structures employed by the PE fund management companies, the amounts earned by the staff co-investment vehicle will flow through to the underlying beneficiaries or limited partners. Whether the staff co-investment vehicle invests directly in the Fund or through the General Partner and ultimately into the Fund, will materially change the type of income earned. The underlying difference between case study one and two is this: with a direct investment into the Fund the value derived on the interest in the staff co-investment vehicle will primarily be capital in nature.

Without considering the PE industry, these arrangements and interests or equity shares would fall within the ambit of section 8C of the Act – due to the inclusion of any contractual right or obligation, the value of which is determined directly or indirectly with reference to a share or member's interest, means these instruments fall within the definition of an 'equity instrument' in terms of section 8C of the Act. In addition, the restrictions imposed by PE fund management company then convert these "vanilla" equity instruments into a 'restricted equity instruments' in terms of the definition provided in section 8C of the Act. The result of such structure, is that the holders of the restricted equity instruments would be subject to income tax on the gain or loss upon vesting. The income tax on the gain or losses earned under a structure in the PE industry will be significantly different to the standard employee share scheme based primarily on the underlying value derived.

The reasons and intentions underpinning these arrangements are consistent with what is seen in a non-PE industry corporate share scheme. Although, once one analyses the underlying

value of these instruments, it is abundantly apparent that there is a catalytic change in the nature of the underlying income.

5 CHAPTER FIVE – CONCLUSION

There seems to be a continued perception that SARS and Treasury view share incentive schemes to be a mechanism used for the avoidance of tax, which poses several threats to the fiscus. The latest amendments to section 8C of the Act, have clearly widened the scope and have reinforced the views of SARS and Treasury, that these schemes are employed for nefarious reasons. The amendments have an effect for all employees within a share incentive scheme and employers who have structured plans to encourage ownership and responsibility of their employees, and those employers seeking to reward employees with an additional financial incentive will be required to make amendments to ensure tax compliance.

There are three factors that must be existent before section 8C of the Act applies – being (a) a causal link between the employer and employee; (b) the issuance of some form of an ‘equity instrument’ by the employer to the employee – which meets the relevant definition; and (c) the imposition of a restriction on the ‘equity instrument’ issued. Once the above has been met, consideration must be given to the date on which the equity instrument will vest in the employee, notable distribution made relating to the restricted equity instrument issued and other transactions concluded. The rights and obligations imposed by the Act on the employee and employer must be given equal standing when operating a share incentive scheme to ensure each party does not fall foul of their duties.

The focus of this paper centers around the vehicles and mechanisms used in the PE industry. The vehicles employed in the PE industry, being a *Bewind Trust* or an *En Commandite Partnership* provide the PE fund management company with tax clarity and an ease of administration for the structuring of a staff co-investment vehicle. Also ensuring the underlying nature of the value derived is retained and passed through to the eventual beneficial owner i.e. the beneficiary or the limited partner respectively. The restrictions imposed on the units or the beneficial interest awarded to or purchased by the fund managers, co-advisors or other staff members draws the ‘equity share’ into the remit of section 8C of the Act.

The ultimate demise applicable to these structures is the manner in which the 'equity shares' in the staff co-investment vehicle derive their value. It is submitted that the primary driver behind the value of these instruments – is the growth in value of the investments held by the PE fund. Which in normal circumstances would capital in nature (dependent on certain factors listed in chapter 4) based on the period of time with which these investments are held and the intention with which these investments are acquired and disposed of.

Due to this, the PE industry faces a situation whereby value created to remunerate and financially incentivize staff member's results in the conversion of amounts that are primarily capital in nature to income in nature.

Within the PE industry, it is submitted that it is necessary to retain employees for the lengthiest time possible, owing to the time it requires to develop a PE funds' track record and build a rapport with current and prospective investors. Ultimately, the retention of key staff members is paramount to the success or demise of a PE fund. Due to the lack of mechanism available to an employer in which to lock in employees of the PE fund manager, the PE industry is driven to implement a share incentive type structure and will eventually face the issues described above.

The enactment of section 8C of the Act was brought about due to the inclination that employee share schemes were counteracting certain provisions of the Act. This section of the Act is to ensure that amounts that are income in nature are classified and taxed as income in nature. The complete opposite effect is being experienced in the PE industry – where amounts which are capital in nature are being converted to income in nature.

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