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**EMPLOYEE SHARE INCENTIVE SCHEMES:
AN INTEGRATED APPROACH**

A thesis presented to the Commerce
Faculty of the University of Cape Town

in partial fulfilment
of the requirements for the
degree of Master of Commerce Taxation

by

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DECLARATION

I, Louise Mercia Bezuidenhout, hereby declare that this thesis is my own original work and that all sources have been accurately reported and acknowledged, and that this document has not previously in its entirety or in part been submitted at any university in order to obtain an academic qualification.

L.M. Bezuidenhout

15 October 2006

ABSTRACT

The problem definition examined in this thesis is how employee share incentive schemes are taxed in the hands of employers and employees. This involved an analysis of the new section 8B and 8C of the Income Tax Act (“the Act”) as well as the old section 8A. Sections 10, 11(a), 56 and the Fourth, Seventh and Eighth Schedules to the Act were also studied. Case law was considered where applicable.

Other areas that were investigated include the impact of IFRS 2 on employee share incentive schemes, the requirements of the Companies Act, the JSE Listing Requirements and Corporate Governance Guidance.

Conclusions are drawn and recommendations include:

- the amendment of certain sections of the Act (including making provision for the deductibility of expenses incurred and settled by way of issuing shares);
- the issue of guidelines by SARS with relation to the taxation of share incentive schemes and the interaction between section 8C and the Eighth Schedule;
- the introduction of a wider selection of “approved” employee share incentive schemes in the line of section 8B to fit the different needs of companies;
- the alignment of the Income Tax Act with the Broad-Based Black Economic Empowerment Act; and
- the availability of public information on employee share incentive schemes.

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CHAPTER 1

INTRODUCTION

1.1 INTRODUCTION AND GENERAL BACKGROUND

Share incentive schemes are used by companies around the world as a mechanism to provide employees with a form of equity-based compensation. Historically, share incentive schemes were only applied in instances where there was direct employee control of a business, for example in the case of co-operative societies. Later on, companies began to realise that employee participation in equity had significant advantages and accordingly schemes were developed to include both management and other employees (Samsa *et al.*, 2003:1).

Ross *et al.* (1996:10) describes the relationship between shareholders of a company, being the owners of the company, and management of a company, being responsible for the day-to-day management of the company, as an agency relationship. An agency relationship exists when someone (the principal) hires another (the agent) to act in his/her best interest. In all such relationships, the possibility of a conflict of interest exists.

It would for example be in the best interest of the shareholders (the principals) if the share price of the company increases as it will increase the value of the shares held by the shareholders but the interests of management (the agents) may lie with protecting job security, maximising remuneration or securing corporate power (Ross *et al.*, 1996:11). Many situations may arise where these two interests will clash such as the case where the shareholders wish to make a risky investment which will impact favourable on the share price but management

wishes not to make the investment because of the possibility of job loss if things turn out badly.

In order to align the interests and goals of management (and other stakeholders such as rank and file employees to a lesser degree) with the interest and goals of the shareholders, share incentive schemes were introduced by companies as they linked the remuneration of management to the share price of the company. This is still generally done by companies allocating shares or share options to management as part of their remuneration packages thereby allowing the financial benefits of equity participation to flow to management but structured in such a way that control remains with the shareholders (mainly through the use of trusts with shareholder appointed trustees).

Towards the second half of the 20th century companies recognised that the benefits of making share incentive plans available to **all employees** included the following (Samsa *et al.*, 2003:1):

1. enhanced employee commitment leading to lower employee turnover;
2. employees seeing direct personal benefits from productivity and profitability increases (to which they can contribute);
3. greater understanding by employees of the relationship between expenses and profitability, often leading to reduced demand for wage increases; and
4. better employee communications, as the company strives to encourage employee equity participation by “selling” the company and its objectives.

Improving profits and performance while managing employee attraction and retention is still driving companies today in selecting equity-based compensation as part of their compensation strategies (PriceWaterhouseCoopers, 2005:1).

Many countries use taxation rules to encourage share ownership amongst employees (Samsa *et al.*, 2003:5). In South Africa however this was not the case until the recent introduction of section 8B of the Income Tax Act No 58 of 1962 (“the Act”) (which can be said not to be particularly generous taking into account the R3 000 per annum limit). Therefore share incentive schemes in South Africa were often structured to fall outside the ambit of the section taxing share incentive schemes such as section 8A and the Seventh Schedule of the Act in order to maximise tax benefits for employees and companies. The deferred delivery option scheme was in many cases successfully structured to get around Section 8A and the Seventh Schedule. Section 8A was applicable to employee share schemes from the 1970 year of assessment to 26 October 2004 and the new section 8C, which seeks to eliminate past tax planning, applies to employee share schemes from 26 October 2004 onwards. Section 8B was also introduced to the Act from 26 October 2004 in order to regulate the tax effects of approved broad-based employee share plans.

1.2 PROBLEM DEFINITION

The main problem examined in this thesis is how employee share incentive schemes are taxed in the hands of employers and employees. This involves an analysis of the new section 8B and 8C of the Act as well as the old section 8A. Section 10, 11(a), 56 and the Fourth, Seventh and Eighth Schedules to the Act are also studied. Case law is considered where applicable.

Other questions investigated are how employee share incentive schemes are accounted for in terms of IFRS 2, i.e. the impact of expensing share-based payments on the choice of scheme, and how the Companies Act, the JSE Listing Requirements and Corporate Governance Guidance affect employee share incentive schemes.

1.3 REASONS FOR THE RESEARCH

The recent introduction of section 8B and 8C to the Act as well as the introduction of the new accounting standard IFRS 2, applicable to financial years beginning on or after 1 March 2005, changed the framework within which employee share incentive schemes were structured and caused companies to revisit the effectiveness of their existing schemes. A detailed analysis is therefore needed in order to establish the underlying principles of the new framework.

Writings on this topic are limited and rarely integrate accounting and other relevant issues with income tax issues. This thesis therefore aims to integrate several aspects relating to the complex topic of employee share incentive schemes.

1.4 RESEARCH OBJECTIVES AND AIMS

The primary research objectives are:

1. To obtain an understanding of the workings of different types of employee share incentive schemes used by companies.
2. To analyse the effect of sections 8A, 8B and 8C on employers and employees involved in employee share incentive schemes.

3. To identify possible problems with current legislation as stated in sections 8A, 8B and 8C.
4. To determine the effect of sections 10 and 56 on employee share incentive schemes.
5. To analyse the deductibility of expenses relating to employee share incentive schemes in terms of section 11(a).
6. To identify and analyse court cases applicable to employee share incentive schemes.
7. To determine the capital gains tax effects of shares bought and sold in employee share incentive schemes.
8. To determine the effects of the Fourth and Seventh Schedule on participants to employee share incentive schemes.

The secondary research objectives are:

1. To obtain an understanding of the workings of IFRS 2 with regards to employee share incentive schemes.
2. To determine the effect of the Companies Act, the JSE Listing Requirements and Corporate Governance Guidance on employee share incentive schemes.

1.5 RESEARCH METHODOLOGY

This thesis is mainly a critical analysis of certain sections of the Income Tax Act as well as a literature study. The information for the literature study is based on:

1. Articles published on various local and international websites.
2. Various tax opinions, surveys and documents obtained from PriceWaterhouseCoopers.
3. Notes from seminars attended.
4. Accounting statements issued by the International Accounting Standards Board.

1.6 ASSUMPTIONS AND LIMITATIONS

This thesis does not distinguish between share incentive schemes for employees and share incentive schemes for executives as the tax and accounting implications are the same in both cases. The Corporate Governance issues discussed in chapter 7 are however only applicable to executives or directors of companies.

This thesis also does not distinguish between share incentive schemes for listed companies and share incentive schemes for unlisted companies as the tax and accounting treatment are again similar although the JSE requirements discussed in chapter 7 are necessarily only applicable to listed companies. Although the determination of the fair value of shares, options, share appreciation rights and similar instruments for accounting purposes will differ for listed and unlisted companies as listed share will inevitably have certain factors such as the market value and volatility readily available, the valuation of such instruments does not form part of the scope of this document.

Chapter 2 describes the workings of a number of share incentive schemes used by companies in South Africa but the list is not intended to be exhaustive as these schemes are tailored to each company's specific needs and therefore many variations of these schemes are in existence.

The taxation consequences discussed in chapter 3 are based on the Act after the 2005 amendments as set out in the Revenue Laws Amendment Act, Act No 31 of 2005, promulgated on 1 February 2006.

1.7 STRUCTURE OF THE STUDY

This thesis consists of seven chapters, a short summary of each are given below:

Chapter 1: Introduction

In this chapter the general background is set out, the problem definition is stated, the research objectives are given and the scope is defined.

Chapter 2: Types of employee share incentive schemes

This chapter describes the workings of some of the share incentive schemes used by companies in South Africa as well as trends in the usage of these schemes.

Chapter 3: Taxation of employee share incentive schemes

The taxation consequences of employee share incentive schemes on employers as well as employees are analysed in this chapter. The chapter groups the taxation effects according to the type of scheme falling within the ambits of sections 8A, 8B or 8C.

Chapter 4: Deductibility of expenses

This chapter discusses the deductibility of expenses (employee costs) incurred by companies in relation to employee share incentive schemes which is settled by way of issuing shares.

Chapter 5: Accounting standard IFRS 2

The accounting treatment of employee share incentive schemes according to IFRS 2 is explained in chapter 5. IFRS 2 differentiates between equity-settled share based payments, cash-settled share based payments and share based payments with cash alternatives. Accounting for deferred taxes is also discussed.

Chapter 6: Other non-taxation related issues

The effect of the Companies Act, the JSE Listing Requirements and Corporate Governance Guidance on employee share incentive schemes are described in this chapter.

Chapter 7: Conclusion

The research results are summarised and conclusion are drawn in this chapter. Recommendations are made and areas of further research are suggested.

1.8 TERMS AND ABBREVIATIONS USED

Throughout this document “section” refers to the sections of the Income Tax Act No 58 of 1962 (“the Act”) and “para” refers to the paragraphs of the Fourth, Seventh or Eighth Schedule to the the Act as specifically stated except for the section dealing with the Companies Act No 61 of 1973 in chapter 6.

The following abbreviations are used in the text:

BBS: Broad-based employee share schemes as described in section 8B of the Act

BEE:	Black economic empowerment as envisaged in the Broad-Based Black Economic Empowerment Act and the Codes of Good Practise issued there under.
CGT:	Capital gains tax
Cr:	Credit
CS:	Traditional convertible preference or debenture schemes
DBP:	Deferred bonus plans
DDS:	Traditional deferred delivery schemes
Dr:	Debit
EPS:	Earnings per share
IAS:	International Accounting Standard
IFRS:	International Financial Reporting Standards
JSE:	JSE Limited (Registration number: 2005/022939/06), a public company incorporated in the Republic of South Africa
LTIP:	Long-term incentive plans including performance shares
Para:	Paragraph
PAYE:	Pay as you earn
PSS:	Phantom share schemes
ROCE:	Return on capital employed
RSA:	Restricted share award schemes
SA:	Republic of South Africa
SA GAAP:	South African Generally Accepted Accounting Practice
SAICA:	The South African Institute of Chartered Accountants

SARB:	South African Reserve Bank
SARs:	Share appreciation right schemes
SARS:	The South African Revenue Service
SOS:	Traditional share option schemes
SPS:	Traditional share purchase schemes
TSR:	Total Shareholder Return
UK:	United Kingdom
US:	United States of America

CHAPTER 2

TYPES OF EMPLOYEE SHARE INCENTIVE SCHEMES

2.1 INTRODUCTION

The types of schemes implemented by companies in South Africa have changed over the last two to three years due to changes in the income tax regulations (discussed in chapter 3), new accounting regulations (discussed in chapter 5) and renewed focus on corporate governance internationally as well as locally (discussed in chapter 6). A distinction is made between appreciation schemes and full quantum schemes and a movement away from appreciation schemes towards full quantum schemes are envisaged (Icely, 2005:4).

In an appreciation scheme, shares or options are granted or sold to participating employees at the grant date market value. The value received by the employee is therefore the net gain from the increase in the market value from grant date to exercise date. In a full quantum scheme shares are granted or sold to participating employee at a nominal value or at a value that is far less than market value (usually par value if par value shares are issued). The value received by the employee is thus the full value of the share at grant date.

The traditional appreciation schemes typically had the vesting of shares subject to certain service related restrictions (requiring the employee to remain employed with the company for a specified period of time) and not performance related restrictions. Many full quantum share schemes such as long term incentive plans and deferred bonus schemes lend themselves to be linked to company performance as well as the performance of the market more easily.

Performance hurdles are particularly applied in schemes for directors and senior executives because of corporate governance regulations.

Institutional investors from the Association of British Insurers (ABI) in the UK issued guidelines to UK listed companies supporting share incentive schemes which genuinely align the interests of participating directors and senior executives with the interests of long-term shareholders. Real shareholder alignment is typically achieved in the case of full quantum shares which provides both upside and downside potential (Icely, 2005:6) in that the employee receives the full value of the share at the grant date. Should the share price thus decrease between the date of grant and the date of vesting, the employee will be in the same position as an ordinary shareholder and could still sell the share at the current market value and realise a benefit. In the case of share options, the employee will not exercise the share options if the share price decreases after date of grant, and will thus not receive any benefit. Full quantum schemes are also seen as less dilutive in that for the equivalent value to the participant, some three to five share options have to be offered (which will eventually be converted to shares) to equal the value of one share (Icely, 2005:7).

This chapter sets out firstly a description of four traditional appreciation schemes and secondly a description of three “full quantum” schemes. The workings of share appreciation rights schemes which can also be applied to phantom share schemes are set out next. Broad based schemes are explained in light of section 8B and foreign schemes are mentioned. The final section of this chapter presents a short summary of the schemes currently being used by listed

companies in South Africa and internationally. (The tax and accounting consequences of each type of scheme are set out in Appendix A.)

2.2 TRADITIONAL APPRECIATION SCHEMES

2.2.1 Share Purchase Schemes

Traditional share purchase schemes typically require the company to set up an employee share trust that will hold shares on behalf of or for the benefit of employees as envisaged in section 38(2)(b) of the Companies Act. The company will provide financial assistance to the trust to purchase or subscribe for shares in the company.

The trust sells the shares to employees at the same value or price that the trust bought the shares from the company (normally at current market value) and delivers the shares to the employees. The purchase price is funded by way of a loan account owing by employees to the employee share trust. The loan account may or may not be interest bearing. The loan is secured by the employee pledging his or her shares back to the employee share trust.

The loan account may not be repaid before the lapse of a specific period or periods during which the employee must remain in the employ of the company (“the release cycle”). Dividends may be appropriated towards the settlement of the loan account.

An inherent disadvantage of the scheme is the risk of a falling share price and the resulting financial loss on the part of the employee as the employee has taken ownership of the shares in terms of a sales contract on credit terms.

2.2.2 Share Option Schemes

Under share option schemes, employees are granted call options by either the company or an employee share trust to purchase or subscribe for the company's shares (usually a specified number of shares), typically at the market price of the shares at date of grant of the options.

The employees may accept the option contract offer resulting in the option contract coming into existence, and the offer to purchase becoming available.

The options may normally only be exercised (and therefore the shares purchased) in tranches after specified vesting periods (the release cycle) at which time the shares may be freely disposed of. For example one third of the options may be exercised after the third year of employment, another third after the fourth year of employment and the final third after the fifth year of employment. The exercise of the option results in the contract of sale coming into existence.

The options expire after a nominated number of years (say ten years) and normally expire if employment terminates before exercise. In some cases performance conditions may need to be satisfied before options can be exercised.

The purchase or subscription price of the shares is only payable by the employee on exercise of the option. An amount may be payable to acquire the option. Employees are under no obligation to acquire shares unless and until they exercise their options. Thus a falling share

price will not result in a financial loss on the part of the employee as they will refrain from exercising their options. The employee will not be entitled to receive dividends until he or she exercises the option.

2.2.3 Deferred Delivery/Allotment Schemes

Deferred delivery schemes have been applied to share purchase plans as well as share option plans. The basic elements of these deferred schemes are similar, i.e. a contract of sale is entered into between the company (or the employee share trust) and the employee in terms of which the company or trust agrees to issue or sell shares to the employee, on the basis that payment for and delivery of the shares is deferred over a certain period/the release cycle.

The subscription or purchase price is the market value of the shares at the date of conclusion of the sales contract but is payable at the time of delivery. Ownership of the shares transfers to the employee only on payment and delivery, thus prior to payment and delivery the employee receives no dividends attached to the shares and has no voting rights.

In the deferred delivery option scheme the specified period between the date of acceptance of the option (bringing into existence the option contract) and the date of exercise of the option or acceptance of the offer to purchase shares resulting in the contract of sale (being the deferred sale mentioned above) is usually very short. The market values of the shares at these dates are thus identical or very close in value. If the option is not exercised within a specified period the option will lapse. Please refer to section 3.2.9 which explains the taxation consequences of these popular schemes.

2.2.4 Convertible Preference Share/Debenture Schemes

Convertible schemes are similar to share purchase schemes except that, instead of ordinary shares being issued to employees, preference shares or debentures in each case convertible into ordinary shares are issued to employees. The convertible preference share/debenture will normally be sold to the employee at a price equal to the ruling market value of an ordinary share. The amount owing by the employee on loan account for the preference shares/debentures purchased carries interest equal to the preferential dividend/debenture interest payable by the company to the employee and is usually also equal to the official rate of interest referred to in Schedule 7 to the Act, creating a cash neutral position for the employee. The preference shares/debentures would be convertible into ordinary shares after the lapse of a desired period (the release cycle), generally on a one to one basis.

2.3 FULL QUANTUM SCHEMES

2.3.1 Restricted Share Award Schemes

These schemes consist of an outright issuance of shares to employees at par value (which is usually insignificant). The shares are most often granted to employees in recognition of service without requiring any payment other than the par value. The vesting of the shares is subject to certain restrictions which may be solely time related (requiring the employee to remain employed with the company for a specified period of time).

A value in currency (which may be based on performance) is usually offered which converts into a number of ordinary shares (at the grant date market value). The employer can recapture

unvested shares allocated to an employee when that employee leaves the employ of the company. To prevent the employee from selling or transferring unvested shares, these are normally kept in an employee share trust.

2.3.2 Long-term Incentive Plans/Performance Shares

Long-term incentive plans or performance shares entails the conditional grant of shares to employees subject to certain market and/or non-market related performance conditions being met over the performance period or the release cycle (usually three to five years). The employee normally does not pay for the shares. A re-testing arrangement may be built into the scheme allowing the extension of the vesting period if the performance hurdle is not met after the initial three year vesting period.

The most common metric for comparative performance is Total Shareholder Return (“TSR”).

TSR can be calculated as follows:

$$\text{TSR} = (\text{Share price at the end of the period} + \text{Dividends} - \text{Share price at the beginning of the period}) / \text{Share price at the beginning of the period}$$

Due to the nature of the calculation, TSR cannot be calculated at divisional level and cannot easily be calculated for private companies. TSR is shown as a percentage and is therefore easily comparable and benchmarked against an industry without worry about size bias. The period used is normally one year or longer. Dividends include all cash payments made to

shareholders. Comparison may be made against an index-related comparator group or a specially selected group of sector-focused businesses.

Other non-market related performance measures such as earnings per share (EPS) and return on capital employed (ROCE) are commonly used in conjunction with TSR.

2.3.3 Deferred Bonus Plans

The purpose of Deferred Bonus Plans is to encourage employees to build up a significant personal stake in the company. In terms of these plans an employee uses part of his/her bonus (net of tax) to purchase shares in the company at the ruling market value. The major driver establishing the bonus amount is generally the annual performance assessment. The shares are held in trust for a specified period, say three years (the release cycle). After the three years, provided that the employee is still employed by the company, the company could match the shares held by the employee in trust, normally on a one-to-one basis, and releases all shares to the employee. Some forms of these schemes also include a performance measure in addition to the time restriction.

Participation in these plans is usually limited to directors and senior management. The employee is the beneficial owner of the shares while held in trust. The employee is thus entitled to receive dividends and may take the shares held in trust if he/she leaves the company at any time before the specified period.

2.4 PHANTOM SHARE SCHEMES/SHARE APPRECIATION RIGHTS

Phantom share schemes or share appreciation rights schemes are a form of appreciation scheme in that the employee/participant benefits from an increase in the market value of the company's shares but does not acquire shares in the company. Many variations of these schemes exist.

Under these schemes a specified number of phantom or notional shares in the company are awarded to the employee at an amount equal to the current market value of the actual shares of the company (the base amount). As these are not actual shares it does not entitle the holder to any rights in respect of actual shares such as the right to dividends or voting rights.

The phantom shares (or share appreciation rights) only vest in the employee after a specified period, usually in tranches. An expiry date is normally stipulated by which time the employee must "cash-in" his/her phantom shares. The "cash-in" price is equal to the market value of actual shares in the company at cash-in date. The employee is paid out the excess of the cash-in value over the base amount (also called the intrinsic value). These pay-outs are effectively bonus payments to employees.

In some forms of these schemes the company may choose to issue actual equity shares or make a cash pay-out at the vesting date, in other forms the employee may choose to receive actual equity shares or a cash pay-out at the vesting date. Performance targets may also be set as vesting conditions.

2.5 BROAD-BASED EMPLOYEE SHARE SCHEMES

The broad-based employee share schemes described here refers specifically to the schemes introduced by section 8B of the Act. Under these schemes employees acquire qualifying equity shares in the company or any other company in the group for a consideration not exceeding the minimum subscription required by the Companies Act. In the case of par value shares, the minimum subscription required by the Companies Act is the par value which is usually an insignificant amount.

Employees who are already participants in other employer share schemes will not be entitled to participate in these schemes. The scheme must be available to at least 90% of all employees other than those participating in other employee share schemes.

The employer will be entitled to issue or sell shares to the value of R9,000 over a period of three years per employee. The employer may restrict the right of the employee to dispose of the shares for a maximum of five years. Section 8B schemes are discussed in more detail in chapter 3.

2.6 FOREIGN SCHEMES

Foreign companies with South African subsidiaries (or branches) may offer participation in a share incentive scheme of the overseas holding company to the South African resident employees of the subsidiary company or branch. The type of scheme could be any of the schemes mentioned above.

The South African resident employees will participate in such a scheme subject to exchange control approval. The SARB application must contain the following:

- Full particulars of the scheme supported by the offer to the employees;
- Number and value of the shares to be taken up;
- Market value of the shares; and
- Method of payment.

SARB approval is restricted to R2 million per resident according to the Exchange Control Manual section F6.1.5. The Manual does not indicate whether the R2 million refers to the market value of the shares but it presumably does as the information requested per the SARB approval includes the market value of the shares. The date at which the market value should be determined is also not specified nor are the consequences of the market value increasing in time beyond the R2 million limit.

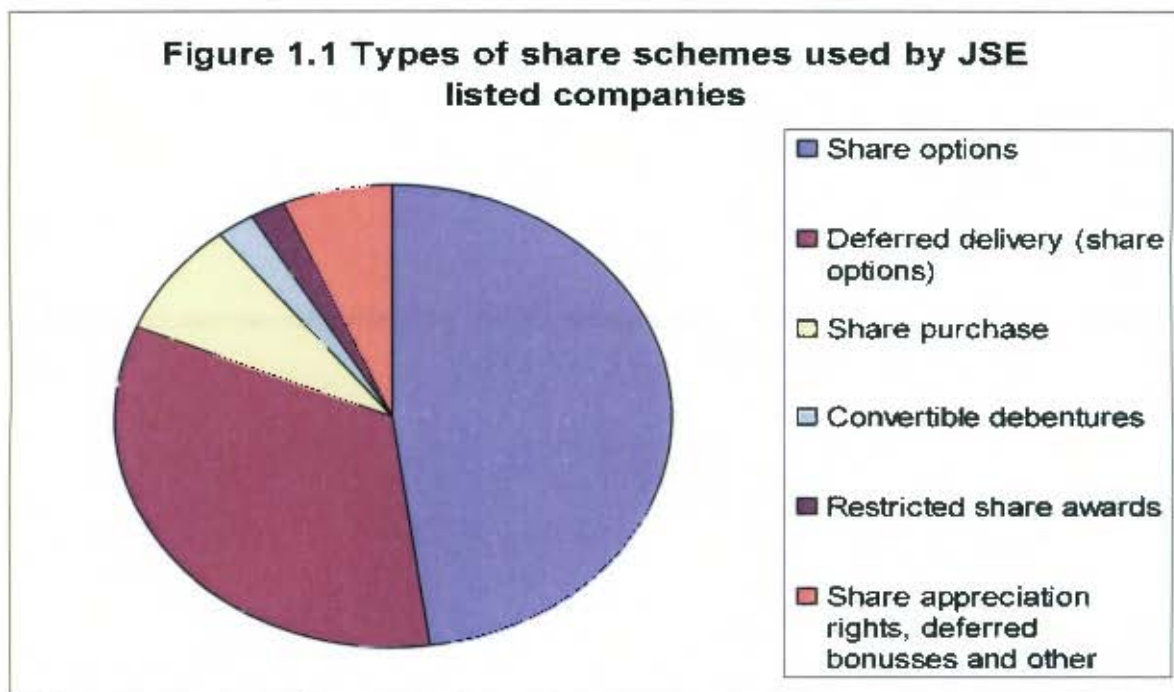
Where shares are taken up for immediate sale abroad, approval is given on condition that all shares must be sold immediately and funds (net proceeds after deduction of related costs) repatriated to South Africa. The SARB will thus allow the transfer of funds as a means of bridge financing.

Should the South African resident employee exceed the R2 million lifetime investment allowances, it may under certain circumstances be possible for the employee to participate in the foreign scheme by means of an offshore parent company loan to the South African resident employee (Ernst and Young, 2006a). The same source indicates that the SARB's current

practice is that shares may be acquired to any value and may be retained abroad provided that there is no recharge to South Africa.

2.7 TRENDS IN THE USAGE OF SCHEMES

The type of schemes used by JSE listed companies in South Africa was tabled in a survey (Thomson, 2005: 11) on share schemes and can graphically be shown as:



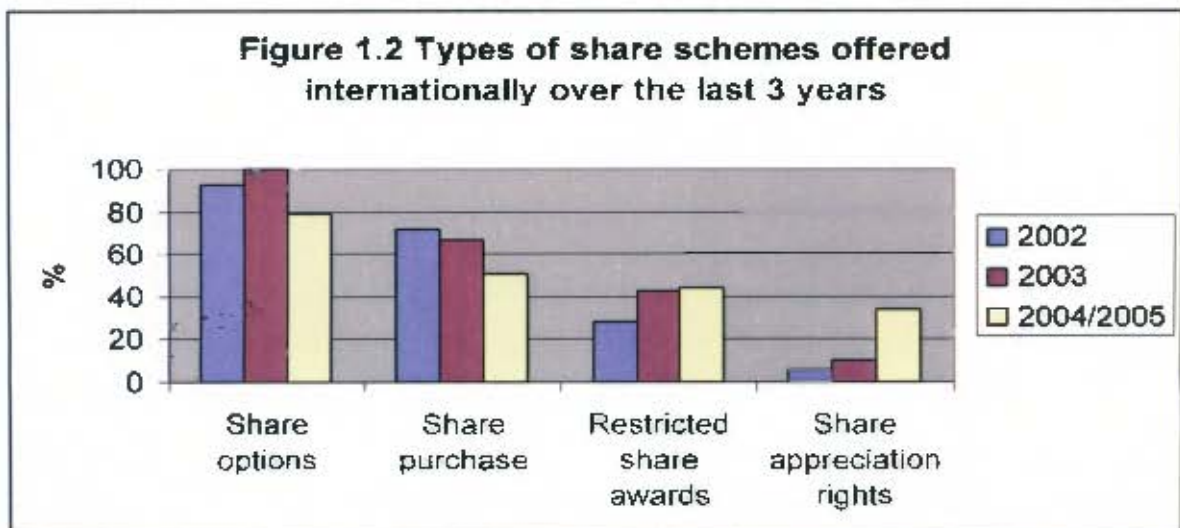
The data in the survey is based on share-based schemes disclosed by 204 JSE listed companies in their most recent annual reports published up to 31 December 2004. This graph would therefore not show the effect of IFRS 2 and sections 8B and 8C of the Act on the type of share schemes implemented by companies as IFRS 2 is only applicable to year-ends beginning after

1 March 2005 and sections 8B and 8C applies to schemes entered into after 26 October 2004.

A similar survey based on 2006 annual reports should show a very different picture.

The survey also states that several companies had by 31 December 2004 already introduced alternative long-term incentive schemes in reaction to the new tax legislation. Extracts from annual reports of companies such as AECI Ltd, Standard Bank of South Africa Ltd, Anglo American Platinum Corporation Ltd, AngloGold Ashanti Ltd, Kumba Resources Ltd, SA Eagle Ltd and Astral Foods Ltd are given showing recent implementation of *inter alia* long term incentive plans, deferred bonus plans and phantom share schemes.

A survey (PriceWaterhouseCoopers, 2005:6) giving details of share schemes operated in 27 countries worldwide including South Africa shows the shift in type of schemes offered to employees as follows:



The decline in traditional share option and share purchase schemes and the increase in restricted share awards and share appreciation rights are evident. The survey also emphasised that companies are uncertain as to how the new expensing regulations will effect share schemes and that companies are much more compliance and corporate governance focussed as a result of the number of corporate scandals that took place internationally in recent years.

CHAPTER 3

TAXATION OF EMPLOYEE SHARE INCENTIVE SCHEMES

3.1 INTRODUCTION

Sections 8A, 8B and 8C deal with employee participation in share schemes. Below follows a description of the workings of these sections. The focus is mainly on the new sections 8B and 8C but section 8A is also explained as it is still applicable to certain types of schemes. Other sections of the Act as well as paragraphs in the Schedules to the Act are also mentioned where relevant.

3.2 SECTION 8A SCHEMES

3.2.1 Introduction

Section 8A was introduced into the Income Tax Act in 1969 and was effective from the 1970 tax year. Section 8A applies to all rights to acquire marketable securities obtained by an employee or director before 26 October 2004. The vesting of all equity instruments acquired by virtue of employment or by arrangement with the taxpayer's employer on or after 26 October 2004 is taxed under section 8C.

The explanatory memorandum (SARS, 2004:10) explains that section 8A failed to keep pace with the myriad of equity-based incentives developed by companies usually for top management and also failed to fully capture all the appreciation of the marketable securities as ordinary income. Thus section 8A was replaced by section 8C.

Section 8A will still be applicable to schemes whereby rights were acquired by employees before 26 October 2004 if those rights will only terminate by exercise, cession or release in the future. The term “any right to acquire any marketable security” does not only refer to options to acquire shares but also refers to rights to acquire shares outright (*SIR v Kirsch*, 40 SATC 95).

3.2.2 Charging section

Section 8A(1)(a) states that a taxpayer must include in his or her income for the year any gain made on the exercise, cession or release of any right to acquire any marketable security. The section applies only if such right was obtained by the taxpayer as a director, a former director or in respect of services rendered as an employee. Paragraph (i) of the gross income definition specifically includes amounts required to be included in the taxpayer’s income in terms of section 8A.

In contrast with section 8C this section does not allow the taxpayer to take losses into consideration and also locks in former directors. The term “marketable security” is defined in section 8A(10) as any security, stock, debenture, share, option or any other interest capable of being sold or exchanged in a share-market.

3.2.3 Election

The taxpayer may elect in writing to SARS to defer the payment of tax from the date of exercise of the right to the date of disposal of the marketable security, if a condition was imposed on the taxpayer by the employer or grantor which prevents the taxpayer from

disposing of the marketable security freely for a certain period of time. If the taxpayer dies or becomes insolvent during the deferral period the gain shall be deemed to have been made on the day before death or insolvency.

3.2.4 Calculating the gain

The gain made by way of exercise is calculated as the difference between the market value of the marketable security (i.e. the share) and the sum of the consideration given for the marketable security (i.e. the share) and consideration given for the right to acquire the marketable security (i.e. the option). A gain made by way of cession or release is calculated as the amount or value of consideration received less the amount or value of consideration given by the taxpayer. The gain will be calculated on the date when the right is exercised, ceded or released.

Consideration given in the form of services rendered or to be rendered or anything done or to be done shall not be deducted from the market value of the marketable security in calculating the gain.

If a right is exercised, ceded or released only in part the consideration given, to be deducted in calculating the gain, shall be apportioned.

3.2.5 Swaps/Restructuring roll-overs

Where a right ("old right") is ceded or released in whole or in part for a consideration which consists of another right to acquire marketable securities ("new right"), the new right shall not

be deemed to be consideration in relation to the old right ceded or released. In other words the cession or release of the old right is disregarded. Any gain made on the exercise, cession or release of the new right shall be included in the taxpayer's income. The consideration given in respect of the old right will be taken into account when calculating the gain of the new right. This may typically happen during restructuring or unbundling transactions.

3.2.6 Relatives/non arm's length roll-back

Certain gains made by relatives of the taxpayer, by persons obtaining rights by way of cession at a non arm's length transaction from the taxpayer and/or persons obtaining rights by reason of the taxpayer's employment are taxed in the hands of the taxpayer under the provisions of section 8A. The cession of shares by the taxpayer to the relative or the other person obtaining the shares at a non arm's length price will thus not give rise to the application of section 8A but any gain made at a later stage by the relative or the other person will result in the gain being included in the taxpayer's income for purposes of section 8A.

"Relative" is defined in section 1 of the Act as the spouse of a taxpayer, or anybody related to either the taxpayer or his or her spouse to the third degree of consanguinity, and the spouse of any such person. A child is deemed to be related to his or her adoptive parents within the first degree of consanguinity. "Child" is also defined in section 1 of the Act.

3.2.7 The employer

There may be a section 11(a) deduction available to the employer with respect to the allocation or issue of options or shares to employees upon the exercise, cession or release of rights to acquire marketable securities. Please refer to chapter 4 for discussions in this regard.

Certain donations tax exemptions are available in terms of section 56(1)(k). The provisions of that section are applicable to section 8A, 8B and 8C instruments and determines that donations tax shall not be payable by the employer company on the value of the shares granted to employees (by virtue of the inclusion in gross income paragraph (i) in the case of section 8A instruments). Donations tax shall also not be payable on section 8A, 8B and 8C gains made by employees (section 56(1)(k)(ii)).

The employer is required to deduct PAYE from section 8A gains made by employees. This is because paragraph (b) of the definition of remuneration in the Fourth Schedule includes amounts included in gross income paragraph (i) which specifically includes amounts required to be included in the taxpayer's income in terms of section 8A.

Detailed provisions relating to the deduction or withholding of employees' tax apply to these section 8A gains which are set out in paragraph 11A of the Fourth Schedule. These section 11A provisions are applicable to sections 8A, 8B and 8C gains.

The provisions determine *inter alia* that if the amount to be deducted is in excess of the consideration/remuneration payable to the employee and as a consequence the employer is

unable to deduct the full amount of employees' tax, the employer must notify the Commissioner immediately.

The provisions also determine that if the employee has made a gain in terms of a section 8A transaction to which the employer is not a party that employee must immediately inform the employer thereof and of the amount of that gain so that the necessary tax can be withheld.

In terms of paragraph 38(2)(a) the employer will not account for CGT on the deemed disposal of a right contemplated in section 8A by way of donation, for consideration not measurable in money or for a price not reflecting arm's length. This paragraph should also apply if the employee disposes of a section 8A marketable security to a relative or to a person at a non-arm's length price. Such a disposal will not be subject to CGT, the "relatives/non arm's length roll-back" provisions of section 8A(6) will apply to tax the eventual gain made by the relative or the other person in the hands of the employee.

3.2.8 The employee

The employee must include in gross income (per paragraph (i) the definition in section 1 of the Act) gains on the exercise, cession or release of rights to acquire marketable securities in terms of section 8A. The employer is required to deduct PAYE from those gains so included.

Amounts received by the employee under an employee share incentive scheme on the cancellation of a transaction or on the repurchase of shares, at a price not exceeding the

purchase price originally paid by the employee for the shares are exempt from tax. This is in terms of the section 10(1)(nE) exemption and is also known as the stop-loss provision.

In terms of paragraph 11A(6) of the Fourth Schedule the employee has an obligation to inform the employer if he has made a gain in terms of a section 8C transaction to which the employer is not a party. Failure to inform the employer will render the employee guilty of an offence and liable on conviction to a fine not exceeding R2 000.

Marketable securities acquired by an employee as contemplated in section 8A are excluded from the definition of taxable benefit in the Seventh Schedule in terms of paragraph 2(a)(ii) of the Seventh Schedule and therefore not included twice in gross income per paragraph (i) of the definition. The acquisition of section 8A shares are thus not seen as assets acquired for no consideration or for consideration less than the value of the asset and are not taxed as fringe benefits.

A loan to an employee for the payment of any consideration for a marketable security contemplated in section 8A at no interest or at a rate lower than the official rate (of nine per cent since 1 September 2006) will give rise to a taxable benefit in terms of paragraph 2 of the Seventh Schedule.

In terms of paragraph 11(2)(k) of the Eighth Schedule the employee will not account for CGT on the disposal of section 8A rights on the cession or release of such rights in whole or in part

for consideration which consists of other rights to acquire marketable securities. This is consequential to the swaps/restructuring roll-over provisions in section 8A(5).

If an employee ceases to be a resident of the Republic within five years of the date of grant, the shares are not deemed to have been disposed of in terms of paragraph 12(2)(a)(iv) of the Eighth Schedule. Paragraph 12 can thus not be used to trigger an early exercise date in terms of section 8A and so limit the gain to be included in income.

If the employee later disposes of a marketable security acquired in terms of section 8A as a capital asset, the marketable security will upon the exercise, cession or release of the right obtain a base cost equal to market value on that date per paragraph 20(1)(h) of the Eighth Schedule and the capital gain or loss made on disposal will therefore be the difference between the consideration for the share on date of disposal and the market value of the share on date of exercise, cession or release of the right.

3.2.9 Discussion points

Deferred delivery schemes

Deferred delivery schemes were probably the most tax efficient schemes during the section 8A era. The deferred delivery option scheme triggers section 8A very early when the option is exercised resulting generally in no gain to be taxed under section 8A. This is because the gain is calculated as the difference between the market value at date of exercise and the consideration given which is usually equal to or very close to that market value (payable at a later point in time). As delivery of the shares and payment for the shares are deferred to a later

date and thus no credit is extended, a low interest or no interest loan does not exist and fringe benefit tax in that regard is also avoided in that regard. The fact that section 8A tax is payable on the gain (even though the gain is zero or close to zero) hinders the application of para 2(a) of the Seventh Schedule and the employee will not be deemed to have received a taxable benefit upon the eventual delivery of the shares.

These deferred delivery schemes were probably the reason why SARS introduced section 8C in 2004. SARS explains amendments to the definition of “restricted equity instrument” in clause 12 of the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2005 as follows:

“One of the most popular methods of avoiding the payment of tax under section 8A, which section 8C has replaced, was to use a deferred delivery mechanism to reduce the amount of the incentive to be taxed in the hands of the employee. This was achieved by entering into a binding contract between the taxpayer and the employer or an associated institution in terms of which an equity instrument was sold to the taxpayer but delivery of the instrument would only be given once payment was made and the employee could only make payment after, say, five years. This ensured no gain or a small gain and no fringe benefit on an interest free loan by the employer. While the view is that the existing paragraph (a) of the definition of “restricted equity instrument” in section 8C already covers deferred delivery schemes as a restriction, as they prevent the taxpayer freely disposing of the instrument, it is proposed that the matter be placed beyond doubt.”

SARS however continues to attack deferred delivery schemes under section 8A possibly because of the limited legal precedent dealing with section 8A (mainly *SIR v Kirsch* 40 SATC 95 and *ITC 1493* 53 SATC 197). The main avenues of attack currently employed by SARS as is evident from PAYE Audit letters issued by SARS Enforcement Cape Town are:

- SARS contends that the difference between the market value of the scheme shares on the date delivered to participants and the offer price constitutes a taxable benefit in

terms of paragraph 2(a) read with paragraph 5 of the Seventh Schedule (assets acquired for no consideration or for consideration less than the value of the asset).

- SARS contends that the employees exercised their right to acquire shares when they received the shares against payment and that section 8A taxes gains at that stage in contrast with the date at which they exercise the option to bring a valid sales contract into existence.
- SARS contends that if the shares were acquired at the date when the sales contract came into existence as apposed to when the shares were delivered against payment, the shares were acquired on credit giving rise to a taxable benefit in terms of paragraph 2(f) of the Seventh Schedule (low interest or no interest loans) because the purchase price remains outstanding.

The paragraph 2(a) of the Seventh Schedule contention

The relevant part of paragraph 2 of the Seventh Schedule reads as follows:

“... a taxable benefit shall be deemed to have been granted by an employer to his employee in respect of the employee’s employment with the employer, if as a benefit or advantage of or by virtue of such employment or as a reward for services rendered or to be rendered by the employee to the employer – (a) any asset consisting of goods, commodity, financial instrument or property of any nature (other than money) has been acquired by the employee from the employer or any associated institution in relation to the employer or from any person by arrangement with the employer, either for no consideration or for a consideration given by the employee which is less than the value of such asset ... : Provided that the provision of this subparagraph shall not apply in respect of – (ii) any marketable security acquired by the exercise by the employee, as contemplated in section 8A, of any right to acquire any marketable security.”

It seems that SARS contends in this regard that the proviso cannot be used to get out of paragraph 2(a) as no gain was made in terms of section 8A when the sales contract came into existence or in other words when the employee exercised the right to acquire the shares.

The proviso to paragraph 2(a) however makes no reference to a gain being made on date of exercise of any right to acquire marketable securities. It is only the exercise of any right to acquire any marketable security in terms of section 8A that prevents paragraph 2(a) from being applied.

I therefore submit that the proviso to paragraph 2 of the Seventh Schedule will apply because a marketable security (a share) was acquired by the employee through the exercise of the right to acquire a marketable security (an option). In deferred delivery schemes the option is exercised almost as soon as it is received by the employee and the share is thus acquired at this stage.

The price of the share when acquired is equal to the market value (resulting in no section 8A gain) but the price is only payable upon delivery of the shares a few years later. The fact that no section 8A gain is made however does not mean that the proviso cannot apply.

Therefore the proviso will apply to preclude the application of paragraph 2(a) which levies fringe benefit tax on the difference between the value of the asset (the share) and the consideration given for the asset at the time when payment and delivery is made.

The section 8A contention

The question in this contention is which event is seen as the “exercise [of] the right to acquire a marketable security” event. SARS contends that when the employee accepts the offer to purchase the shares i.e. when the sales contract comes into existence the employee merely acquires a right to purchase and that the right is only exercised at the date when delivery and payment is made. The gain should according to SARS be calculated on the date of delivery and payment based on the difference between the market value of the shares and the purchase price of such shares at that date.

In *SIR v Kirsch* 1978 (3) SA 93 (T) Coetzee J compared the tax consequences of an option and an outright sale in terms of section 8A and stated that:

“... in both cases liability for tax arises when the offers are accepted, not before. This ‘difference’ is non-existent. The only real difference in law between the two classes [options and outright sales] is that in the case of the first the offer is irrevocable (usually for a period) and in the case of the second it is revocable at will. The legal results in all respects, of acceptance, in both cases are identical. At the moment the [sales] contract comes into being and only then an obligation to allot the shares arises.”

In other words the exercise of the right to acquire shares referred to in section 8A takes place, in the case of an option as well as in the case of an outright sale, when the contract of sale comes into existence and the liability for tax arises at that point.

ITC 1493 53 SATC 197 sets out the nine prerequisites of section 8A(1)(a) and Melamet J comments on the right to acquire a marketable security as well as the exercise of the right as follows:

“It matters not ... whether the right is a simple offer, which, upon acceptance by the offeree will bring into existence a contract for the acquisition of the shares, or whether the right is an option to acquire shares and upon the exercise of which a contract for the acquisition of the shares is perfected. The right contemplated in the sub-section is the right enjoyed by a taxpayer to bring into existence by his voluntary and unilateral act of exercise or acceptance a contract which entitles him to claim the shares ... The right envisaged in section 8A(1)(a) is the right to bring into existence a contract of sale or allotment by way of the director or employee exercising that right. This leads to the creation of new rights flowing from the contract entitling the employee or director to enforce the terms of the contract ... There must be a valid exercise of the right ... because it is only on such exercise that the notional or deemed gain referred to in section 8A(2)(a) can apply. It is clear from the section that the date at which the value of the marketable securities is to be determined is the date on which the right is exercised by the taxpayer.”

Again it is clear that the right referred to in section 8A which triggers the gain to be calculated is the exercise of the right which brings into existence the sales contract.

The question that follows is whether a binding contract of sale is concluded upon the exercise of the option to purchase shares when the payment and delivery is deferred to a later date or whether a contract of sale only comes into existence upon the payment and delivery of the shares.

The general principles of contract law distinguish between the terms and conditions of a contract. Terms of a contract regulate the manner in which the obligation in the contract will be executed, whereas conditions of a contract influence the existence of the contract itself i.e. suspensive or resolutive conditions. The difference between terms and conditions was explained in *Design and Planning Services v Kruger* 1974 (1) SA 689 (T) as:

“In the case of a suspensive condition, the operation of the obligations flowing from the contract is suspended, in whole or in part, pending the occurrence or non-occurrence of a

particular specified event ... A term of the contract, on the other hand, imposes a contractual obligation on a party to act, or to refrain from acting, in a particular manner."

Provisions of a contract regulating when payment and delivery will be made, appear to be terms of a contract as opposed to true conditions of a contract as the validity or existence of the contract is not affected by such terms.

The alternative view is that the deferral of the obligations to pay for the shares and to deliver the shares renders the contract subject to a suspensive condition and therefore a valid contract of sale only comes into existence once the condition is fulfilled. "Suspensive condition" is defined by Van der Merwe, *et al.*, 2003 as a condition that suspends or postpones the full operation of the obligations until certainty is reached that the condition is fulfilled or that it fails. And the most important characteristic of a condition is said to be that it relates to an uncertain future event.

Van der Merwe, *et al.*, 2003 defines a "time clause" as a contractual term which qualifies an obligation with reference to a certain moment or event in the future. And a "suspensive time clause" renders obligations into existence when the contract is concluded, but the full operation of the obligations is postponed until the future event.

In my opinion a binding agreement of sale is concluded when the option is exercised. I submit that the deferral of the obligations is not in itself an uncertain future event and thus not a condition but rather a time clause. The time period relating to the deferral of the obligations is usually a fixed number of years from the date of grant and can in my opinion also not be seen

to be an uncertain future event. The fact that the employee will forfeit his shares if he resigns before the time period ends would in my opinion constitute a resolutive condition as the contract between the employee and the employer will terminate when the employee resigns. This again means that a binding sales contract comes into being from the date when the option is exercised.

Another aspect which the courts will consider is the true intention of the parties, thus whether if the employer and the employee intend that the option be exercised almost simultaneous to the option being made available to the employee resulting in a minimal section 8A gain, it can be said that a genuine option exists. Van der Merwe, *et al.*, 2003 states that an option contract creates at least one obligation which is on the option grantor to keep the offer open for acceptance to the option holder. It is not stated what a reasonable period is for the offer to be kept open by the grantor.

It was said in *Kilburn v Estate Kilburn* 1931 AD 501 that the courts will not be deceived by the form of a transaction but will examine its true nature and substance.

Also in *Zandberg v Van Zyl* 1910 AD 302 it was said that:

“Not frequently, however (...) the parties to a transaction endeavour to conceal its real character. They call it by a name, give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what it purports to be ... But the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the

circumstances, that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be."

And Watermeyer JA in *Commissioner of Customs and Excise v Randle, Brothers & Hudson Ltd* 1941 AD 369 stated that:

"A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibitions in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax.

*A disguised transaction in the sense in which the words are used above is something different. In essence it is a **dishonest transaction**: dishonest, in as much as the parties to it do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax. Such a transaction is said to be in fraudem legis, and is interpreted by the courts in accordance with what is found to be the real agreement or transaction between the parties.*

*Of course, before the court can find that a transaction is in fraudem legis in the above sense, it must be satisfied that there is **some unexpressed agreement or tacit understanding** between the parties. If this were not so, it could not find that the ostensible agreement is a pretence."* (emphasis added)

I submit that a deferred delivery option scheme under the old section 8A rules would not likely be seen as a disguised transaction because there is no unexpressed agreement or tacit understanding involved. It is expressed and clear that the parties intend to contract by means of an option contract as well as a sales contract and there is no other unexpressed agreement. The fact that the law allows for a contract to be structured in many ways by the parties agreeing on different terms and conditions does not render structured contracts dishonest transactions. If the parties by concluding an option contract before a sales contract almost totally eliminates the section 8A gain, and the parties honestly intend to conclude the two contracts even though the

option contract is in existence for only a short period of time, the courts are likely interpret the contracts according to its tone.

The paragraph 2(f) of the Seventh Schedule contention

The relevant part of paragraph 2 of the Seventh Schedule reads as follows:

“...a taxable benefit shall be deemed to have been granted by an employer to his employee in respect of the employee’s employment with the employer, if as a benefit or advantage of or by virtue of such employment or as a reward for services rendered or to be rendered by the employee to the employer – (f) a loan ... has been granted to the employee, whether by the employer or by any other person by arrangement with the employer or any associated institution in relation to the employer, and either no interest is payable by the employee on such a loan or interest is payable by him thereon at a rate of lower than the official rate of interest.”

Paragraph 1 of the Seventh Schedule defines the word “loan” as including any form of credit and any loan applied directly towards the replacement of any other loan.

The question is whether the amount to be paid for the shares on delivery thereof constitutes a loan that should have carried interest, from the date of entering into the sales contract to the date of payment and delivery, for the purposes of determining a taxable benefit granted to the employee.

Therefore for the amount to constitute a loan as defined a form of credit must have been granted. The ordinary meaning of obtaining credit has been discussed in several cases for example in *S v Clifford* 1976 (1) SA 695 (A) Corbett JA stated that:

“... since in a contract of sale of a movable, payment and delivery must at common law be made pari passu, the contractual term allowing of payment one month after delivery would amount to an obtaining of credit.”

Since payment and delivery are made simultaneously in the case of deferred delivery schemes, it cannot be said that credit is granted to employees and therefore a taxable benefit does not exist in terms of paragraph 2(f) of the Seventh Schedule.

3.3 SECTION 8B SCHEMES

3.3.1 Introduction

An employee, acquiring qualifying equity shares (“the shares”) in terms of an approved broad-based employee share plan (“the plan”) on or after 26 October 2004, which does not dispose of such shares within five years from date of grant will not include the gains made on disposal in income but will generally be subject to capital gains tax on such gains. The initial grant by the employer or share trust or company in the same group of companies of the shares is exempt from tax in the hands of the employee. The employer will receive a tax deduction equal to the market value of the shares granted limited to an annual maximum per employee.

The purpose of section 8B according to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 is to promote long-term employee empowerment by allowing employees to participate in the success of their employer through the acquisition of shares at minimal cost and without adverse tax consequences. It is also stated that the acquisition of

shares by employees can motivate productivity and that broad based participation is in line with good corporate governance.

3.3.2 The Plan

The term “broad based employee share plan” is defined in section 8B(3) as a plan in terms of which:

- Employees acquire shares for no consideration or the minimum consideration as required by the Companies Act, 1973 (Act No. 61 of 1973). This in effect means that the consideration should not exceed par value if par value shares are issued and that existing shares can be given to the employee for no consideration.
- Employees acquire shares in the employer or in a company in the same group of companies as the employer. Group of companies is defined in section 1 of the Income Tax Act as two or more companies in which the controlling group company directly or indirectly (with other controlled group companies) holds at least 70 per cent of the equity shares in the controlled group company/companies and the controlling group company holds at least 70 per cent of the equity shares in one controlled group company directly.
- Employees participating in other equity schemes of the employer or another company in the same group of companies as the employer may not participate in the broad-based employee share plan.
- 90 per cent of employees not participating in other equity schemes are entitled to participate in the broad-based employee share plan.

- Only permanent employees who have been employed on a full-time basis for at least one year prior to the date of grant are entitled to participate in the broad-based employee share plan.
- Employees are entitled to full dividend and voting rights in relation to the shares.
- No restrictions have been imposed on the disposal of the shares other than a restriction imposed by legislation or a right of any other person to acquire the shares at full market value (a clause common to unlisted companies wanting to prevent outside parties from acquiring of the shares) or a restriction by the employer on the employee's right to dispose of the shares but the restriction may not extend beyond five years of grant date of the shares. The plan may thus impose a restriction on disposal of up to five years from grant date. It also seems that the employer cannot force the employee to dispose of his/her shares if he/she leaves the employ of the company within the five year period as no restrictions on the disposal of the shares are allowed, other than the restrictions just mentioned above. When the ex-employee wished to dispose of the shares after five years, the employer may however enforce its right to repurchase the shares (an allowable restriction per section 8B).

“Date of grant” is defined in section 8B(3) as the date on which the granting of equity shares is approved by the directors or some other person or body with comparable authority conferred under the memorandum and articles of the employer company.

3.3.3 The Shares

The term “qualifying equity share” is defined in section 8B(3) as:

- An equity share. The term “Equity share” is construed from the definition of “equity share capital” defined in section 1 of the Income Tax Act as any share in the issued capital of a company but excluding any part thereof which may not participate beyond a certain amount in a distribution in respect of dividends or capital, thus typically excluding ordinary preference shares.
- Acquired in terms of a broad-based employee share plan.
- Where the market value of all equity shares acquired in the current and immediately preceding two years of assessment does not in aggregate exceed R9,000. The market value of all qualifying equity shares excludes the market value of any qualifying equity share acquired by virtue of holding a qualifying equity share for example shares obtained in a capitalisation issue.

“Market value” in relation to an equity share is defined in section 8B(3) as the price which would be obtained upon the sale of that equity share between a willing buyer and a willing seller dealing freely at arm’s length in an open market and without having regard to any restrictions imposed on those shares.

3.3.4 The employer

The employer may deduct from income in terms of section 11(1A) an amount equal to the market value of any share granted to an employee in terms of section 8B at grant date less any consideration given by the employee up to a maximum of R3 000 per employee in any year of assessment. So much as exceeds R3 000 may be carried forward to the immediately succeeding year of assessment.

In terms of section 56(1)(k)(i) donations tax shall not be payable by the employer company on the value of the shares granted to employees (by virtue of the inclusion of the value of the equity instruments in gross income paragraph (c)) or on gains made by employees (section 56(1)(k)(ii)).

The definition of remuneration in the Fourth Schedule excludes the value of any qualifying equity shares contemplated in section 8B by virtue of the exclusion from taxable benefits as described in paragraph 2 of the Seventh Schedule. (Paragraph (b) of the definition of remuneration includes amounts of taxable benefits to be included in paragraph (i) of the gross income definition.) As a consequence no employees' tax is deductible by the employer on the value of such shares.

The definition of remuneration (paragraph (d)) includes any gain determined in terms of section 8B and employees' tax must be deducted or withheld by the employer from consideration paid or payable to the employee in respect of the cession, release or disposal of the qualifying equity shares or from any cash remuneration payable to the employee after, to the knowledge of the employer, that share has been disposed of within a period of five years from date of grant.

Specific provisions relating to the deduction or the withholding of employees' tax apply to section 8B gains and are set out in paragraph 11A of the Fourth Schedule. These provisions apply to sections 8A, 8B and 8C and were discussed under section 8A above.

Shares issued by a company to employees will not give rise to a capital gains tax event as the issue of share is specifically excluded from the definition of disposal per paragraph 11(2)(b). If a share trust grants shares to employees of the company a capital gains tax event will arise as the granting of shares is a disposal per the definition.

Assets or shares disposed of by means of a donation or shares disposed to a connected person for a price not reflecting an arm's length price are regarded as being disposed of and acquired at market value for the purposes of paragraph 38 of the Eighth Schedule. But the disposal of qualifying equity shares contemplated in section 8B by an employer to an employee is excluded from the above provision per paragraph 38(2)(c).

When a share trust re-acquires shares from employees at a market value as contemplated in section 8B(3)(d)(ii) those re-acquired shares are held by the share trust at that market value which will be the new base cost of the shares per the normal CGT rules.

3.3.5 The employee

The value of the shares received by employees from employers in terms of the plan are included in the gross income of employees by virtue of paragraph (c) of the gross income definition which states that any amount, including any voluntary award, received or accrued in respect of services rendered or any employment shall be included in gross income. But section 10(1)(nC) exempts from gross income any amount received by or accrued to a person in the

form of a qualifying share contemplated in section 8B. Thus employees receive these shares free from tax.

The value of the shares acquired by an employee as contemplated in section 8B are also excluded from the definition of taxable benefit in the Seventh Schedule by virtue of the section 10 exemption as well as in terms of paragraph 2(a)(iii) of the Seventh Schedule and are therefore not included in paragraph (i) of the gross income definition. The acquisition of section 8B shares is thus not seen as assets acquired for no consideration or for consideration less than the value of the asset and are not taxed as fringe benefits.

A loan to an employee for the payment of any consideration for a qualifying equity share contemplated in section 8B at no interest or at a rate lower than the official rate will not give rise to a taxable benefit in terms of paragraph 2(f) of the Seventh Schedule and is thus free from fringe benefit tax. A loan to the employee is however unlikely to occur seen as shares are acquired at par value which is usually nominal.

The employee will include gains made from the disposal of broad-based shares within five year from date of grant in their income per section 8B(1). The employer will deduct employees' tax from these gains. Although this may seem harsh to deduct tax at the marginal rates from these targeted low to middle income employees if they dispose of the shares within the five year period it seems that that was the intention of the legislator. The explanatory memorandum (SARS, 2004:8) explains that the different treatment (income tax payable on disposals before

five years and CGT on disposals after five years) creates another incentive for the employees to retain their shares for more than five years.

Gains from disposals of shares in exchange for other qualifying equity shares (as a result of a subdivision, consolidation, conversion or restructuring) as well as disposals on the death or insolvency of a person are not included in the income of a person.

Gains from the disposal of the shares after the death of a person by the executor of the estate will also not be included in the income of the estate or of an heir as the provisions of section 25 will not apply (per section 8B(4)).

“Gain” is defined in section 8B(3) as the amount by which any amount received by or accrued to that person from the disposal of the shares exceeds the consideration given by him for those shares otherwise than in the form of services rendered, services to be rendered, anything done or to be done. In other words the gain is calculated as the proceeds from disposal less the minimum consideration as referred to in section 8B(3)(a).

If a person disposes of a share (“old share”) as a result of a subdivision, consolidation, conversion or restructuring of the equity shares of the company (or any other company in the same group of companies) in exchange solely for any other qualifying equity share (“new share”), the new share is deemed to be acquired on the same date and for the same consideration as the old share.

If a person acquires any additional shares by virtue of qualifying shares held (such as shares obtained in a capitalisation issue), such additional shares acquired are deemed to be qualifying shares acquired on the date of grant of the original shares.

If a person disposes of a right or interest in qualifying shares held, the acquisition cost is apportioned as follows:

$$\text{Acquisition cost} \times \frac{\text{Consideration received for disposal}}{\text{Market value of all shares immediately before disposal}}$$

In terms of paragraph 11A(6) the employee has an obligation to inform the employer if he has made a gain in terms of a section 8B transaction to which the employer is not a party. Failure to do so will render the employee guilty of an offence and liable on conviction to a fine not exceeding R2 000.

If an employee ceases to be a resident of the Republic within five years of the date of grant, the shares are not deemed to have been disposed of in terms of paragraph 12(2)(a)(ii) of the Eighth Schedule.

3.3.6 Discussion points

Interaction with section 9B

SARS chose not to amend section 9B in order to provide for shares held under section 8B for periods longer than five years, as was recommended by SAICA in their letter dated 11 July

2005. The disposal of section 8B shares after a period of five years from date of grant will thus be taxable according to the normal capital gains tax rules. Should the share be affected shares, thus listed shares held for at least five years, the employee could elect to have the gain treated as capital in terms of section 9B. The effect in my opinion would be the same.

Definition of “qualifying equity shares”

Some writers contend (LexisNexis Butterworths, 2005:16) that if shares in excess of R9 000 are granted in the three year period, the first R9 000 will not attract normal tax if disposed of after the five year period but the excess will. I however submit that if shares in excess of R9 000 are granted in the three year period, the shares will not fall within the definition of “qualifying equity shares” and section 8B will not be applicable. This will have the effect that the initial grant will be included in the income of the employee subject to normal tax as the section 10(1)(nC) exemption will not be available. The tax effects on disposal will depend on the intention of the employee regarding the holding of the shares (i.e. on capital account or as trading stock).

Interaction with the BEE Act and Codes

An ideal opportunity for employers to include or introduce rank-and-file employees to share schemes presents itself when employers introduce black ownership to a company as specified in the BEE Act and Codes. Although it must be conceded that the purpose of introducing section 8B to the Act was clearly not to give tax relief to employers implementing BEE transactions, the limit of R9 000 in market value of shares over a three year period does not allow for medium and large sized companies to largely make use of section 8B schemes when

implementing BEE transactions as broad-based as possible thereby largely including black employees if they so wish.

An example will illustrate: Assume a medium to large sized company wishes to have black ownership of 25 per cent (depending on the industry that the company operates in, the applicable charter may require a specific percentage black shareholding) and say the market value of the company is R3 billion. The total market value of the shares marked for black ownership would therefore be R750 million (R3 billion * 25%). Assume further that the company has 5000 black employees whom have never participated in an employee share scheme. If the company was to use a section 8B scheme to allocate shares to black employees for purposes of the BEE transaction only R45 million ($R9,000 * 5000$) or 1.5 per cent of the company's total shareholding can be taken up by black employees under a section 8B scheme.

If these low to middle income black employees were to want to participate further in the company's BEE transaction they would have to obtain the necessary funding and participate as members of the public. In many BEE transactions financing structures (such as preference share financing) are put in place by the company which may decrease the amount payable by the new black shareholders for the shares. It is however not the objective of this paper to analyse finance structures or BEE transactions. It is suffice to say that an ideal opportunity for rank and file employees to participate as shareholders in a company presents itself when BEE transactions are implemented which cannot be fully utilised under section 8B at present due to the current limits imposed by section 8B.

Balshaw (2005:190) observed that the government has failed to provide any broad-based BEE-related tax incentives or benefits but that creating real investment incentives, tax breaks and subventions linked to transformation should be high on the government's agenda.

The issue of the low limit of R3 000 per year was raised by the Portfolio Committee on Finance and the Select Committee on Finance and SARS responded in a letter dated 8 November 2004 as follows:

"The proposal is intended to be of great assistance to rank-and-file employees who earn an average of R50 000 to R70 000 per annum and was eventually pitched at 5 per cent of the SITE amount limitation.

Reasons for the low amount include:

- *It will limit abuse in the form of deferred compensation arrangements;*
- *It will limit the temptation to "cash-out" by resigning or entering into further schemes like the disposal of dividend rights;*
- *A deduction will be allowed to the employer hence the need to **limit revenue exposure for the fiscus.*** (Emphasis added)

Balshaw (2005:190) commented that many would argue that the R3 000 per year free grant is miniscule and of a token nature and added that these employee share plans require a high level of maintenance and are administratively costly.

In my opinion the possibility of the limit being raised by SARS in order to align the tax treatment with the BEE charters and codes appears to be slim but is much needed.

3.4 SECTION 8C SCHEMES

3.4.1 Introduction

Section 8C deals with the taxation of employees and directors on the vesting of equity instruments acquired on or after 26 October 2004. Section 8C replaces section 8A which deals with rights to acquire marketable securities obtained before 26 October 2004.

3.4.2 The charging section

Section 8C applies notwithstanding sections 9B and 23(m) meaning that section 8C takes preference over section 9B and 23(m) or as the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 puts it: “This rule overrides the 5-year capital gain rule for listed shares under section 9B and the limitation of deductions of employees under section 23(m).”

In essence section 8C requires a taxpayer to include in his/her income any gain or deduct from his/her income any loss with regards to the vesting of any equity instrument, if such instrument was acquired by the taxpayer:

- By virtue of his employment or office as director or from any person by arrangement with the taxpayer’s employer (“employer” as defined in the Seventh Schedule); or
- By virtue of any other instrument held by the taxpayer in respect of which section 8C will apply (referring to equity instruments acquired as a result of corporate restructurings such as capitalisation issues).

“... By arrangement with the taxpayer’s employer ...” was added in the 2005 amendments in order to widen the scope of the section.

Section 8C does not apply to equity instruments which fall within the definition of qualifying equity share as envisaged in section 8B. Section 8C is also not applicable to equity instruments acquired by exercise or conversion of, or exchange for, any other equity instruments where those other equity instruments have been subjected to the provisions of section 8C upon vesting. This latter exclusion refers to shares obtained by exercising options to acquire such shares where the gain or loss upon the vesting of the option was already taxed under section 8C.

3.4.3 Equity instrument

“Equity instrument” is defined in section 8C(7) as a share or part of a share in the “equity share capital” of a company or member’s interest in a closed corporation. Equity share capital is defined in section 1 and was explained in part 3.3.3 above. The definition further specifically includes an option to acquire such share or member’s interest and any financial instrument that is convertible to such a share or member’s interest. “Financial instrument” is defined in section 1 of the Act.

3.4.4 Vesting rules

The vesting rules are explained in section 8C(3) and are allocated between rules for restricted equity instruments and rules for unrestricted equity instruments.

“Restricted equity instruments” is defined in section 8C(7) and consists of seven restriction categories:

- **Disposal restrictions:** These are equity instruments subject to restrictions preventing the taxpayer from freely disposing of those instruments at market value. These restrictions exclude restrictions imposed by legislation.
- **Forfeiture restrictions:** These are equity instruments subject to restrictions that could cause the taxpayer to forfeit ownership or the right to acquire ownership at a value lower than market value.
- **Right to impose the above two restrictions:** These are equity instruments subject to any person imposing the restrictions mentioned above such as where a shareholder of the employer company has the right or option to purchase the shares at cost from the employee upon leaving the employer company within a specified period.
- **Options on restricted equity instruments:** These are equity instruments in the form of options which will upon exercise result in the taxpayer acquiring restricted shares (or other restricted equity instruments).
- **Financial instruments convertible into restricted equity instruments:** These are equity instruments in the form of convertible financial instruments that will convert into a restricted equity instrument.
- **Employee escape clause:** These are equity instruments with conditions stipulating that the employer will cancel or repurchase the instrument (at a price exceeding the market value on the repurchase date) if the instrument declines in value after acquisition. “Employer” for the purposes of this restriction also includes an associated institution as defined in the Seventh schedule and any other person by arrangement with the employer company. An associated institution is essentially, where the employer is a company, any other company managed or controlled, directly or indirectly by the same

persons and where the employer is not a company, any other company managed or controlled, directly or indirectly by the employer or any partnership which the employer is a member of.

- **Deferred delivery mechanism:** These are equity instruments which are restricted by not being deliverable to the taxpayer until the happening of a fixed or contingent event, excluding the requirement to pay for the instrument at a later stage.

Restricted equity instruments vest at the earliest of:

- When all restrictions cease to exist; or
- Immediately before the taxpayer disposes of the instrument except where the disposal results in the acquisition of other equity instruments due to for example corporate restructuring discussed in 3.4.6 below and disposals to connected persons or disposals not at arm's length discussed in 3.4.7 below; or
- Immediately after an option or a convertible instrument terminates, excluding terminations by way of exercise or conversion of the instruments; or
- Immediately before the taxpayer dies if all restriction are or may be lifted on or after death.

Unrestricted equity instruments are all other equity instruments which do not fall within the above seven restriction categories. An unrestricted equity instrument vests at the time of acquisition of that instrument.

Applying the vesting rules to share options it is clear that a restricted option which terminates upon exercise into a restricted share will not trigger a vesting event upon termination due to the third vesting rule for restricted instruments. The restricted share will trigger a vesting event when for example all restrictions fall away.

An unrestricted option will trigger a vesting event when acquired. When the unrestricted option is later exercised into an unrestricted or restricted equity instrument and that equity instrument vests, section 8C will not apply due to the workings of section 8C(1)(b)(i), which states that section 8C shall not apply to equity instruments acquired by exercise of other equity instruments that have been subject to section 8C, and therefore the shares acquired upon exercise of the option will not be subject to section 8C.

3.4.5 Calculating gains or losses

Gains or losses are calculated in a similar way, divided into two categories:

- In the case of disposals in terms of section 8C(5)(c), which refers to taxpayers disposing of restricted instruments back to employers for amounts less than market value, and disposals by way of release, abandonment or lapse of options or convertible instruments the gain or loss is calculated as: The difference between the amount received or accrued by the taxpayer on disposal of the instrument and the amount of consideration given or to be given by the taxpayer (or connected person or non arm's length person described in 3.4.7 below) in respect of the acquisition of the instrument.
- In all other cases the gain or loss is calculated as the difference between the market value of the instrument at time of vesting and the amount of consideration given or to

be given by the taxpayer, connected person or non arm's length person in respect of the acquisition. "Market value" is defined in section 8C(7) and is similar to the definition of market value in section 8B with the addition that in the case of a restricted equity instrument, the price had the restrictions not existed equals the market value.

"Consideration" is defined in section 8C(7) and means any amount given or to be given other than services rendered or to be rendered or anything done or to be done or not to be done. The wording is again similar to the wording in section 8B but the definition in section 8C describes three categories of persons by whom the consideration are given:

- By the taxpayer for the equity instrument.
- By the taxpayer for another equity instrument which was disposed of in order to obtain this equity instrument typically due to a reorganisation. That consideration must be reduced by consideration attributable to the gain or loss recognised on the portion of the reorganisation swap received in cash, or something other than a restricted equity instrument, if any.
- By any person which is a connected person in relation to the taxpayer or by a person whom acquired a restricted equity instrument from the taxpayer at a non arm's length price or by any other person whom acquired an equity instrument by virtue of the taxpayer's employment or office of director. Consideration does not include any amount given or to be given by that person to the taxpayer or another connected person.

The definition of consideration also includes two provisos, namely:

- Where a taxpayer acquires an equity instrument in exchange for another (in for example a restructuring), the market value of the instrument given in exchange does not form part of consideration in respect of the newly acquired instrument; and
- Where a taxpayer acquires an option or a right to acquire any marketable security (“new option”) in exchange for another option (“old option”) and the new option is an equity instrument acquired in accordance with section 8C, the market value of the old option does not form part of consideration in respect of the new option.

The provisos thus in effect provide that the swap of instruments in terms of a restructuring or reorganisation is seen as a non-event for the purposes of determining a gain or loss in terms of section 8C. The gain or loss will be determined when the newly acquired instrument vests taking into account the original consideration given and making adjustments for other payments received as a result of the restructuring or reorganisation. Also refer to restructuring roll-overs below.

3.4.6 Restructuring roll-overs

During a restructuring or reorganisation it often happens that equity instruments acquired by the taxpayer from the employer are swapped or disposed of for other equity instruments acquired from the employer or an associated institution or another person by arrangement with the employer. In cases like these the newly acquired instruments are deemed to be acquired by the taxpayer by virtue of his or her employment or office of director and will be subject to the provisions of section 8C.

If any payment in a form other than the new restricted instruments is received, a gain or loss must immediately be recognised taking into account the portion of consideration attributable to the payment. The calculation is thus as follows:

Gain/loss = Payment received – Consideration attributable

$$\text{Consideration attributable} = \frac{\text{Payment received}}{\text{Total swap receipts}} \times \text{Original consideration paid}$$

3.4.7 Connected person/non arm's length roll-backs

If an equity instrument is disposed of by the taxpayer to a connected person, in relation to the taxpayer, as defined in section 1 of the Act or to any other person in a non arm's length transaction the provisions of section 8C relating to vesting, calculation of gains and losses and the roll-over provisions described in 3.4.6 above apply *mutatis mutandis* as if the other person had been the taxpayer and the gain or loss is deemed to be made by the taxpayer.

In other words there is no tax event when the employee disposes of shares acquired in terms of section 8C to a connected person but when the shares vest in the hands of the connected person the tax consequences are for the taxpayer.

If an equity instrument is acquired by any other person by virtue of the taxpayer's employment or office of director, such as the spouse of an employee, the instrument is deemed to be

acquired by the taxpayer and the provisions of section 8C relating to vesting, calculation of gains and losses and the roll-over provisions described in 3.4.6 above apply to the taxpayer.

In the situations mentioned here the taxpayer will be deemed to have donated the equity instrument per section 58(2) to the person at the time of vesting at fair market value less any consideration in respect of that donation paid or payable. Donations tax is currently payable at a rate of 20 per cent. Section 56(1)(b) however exempts any donation to the spouse of the donor from donations tax.

If the connected person, the person party to a transaction not at arm's length or the other person whom acquired instruments by virtue of the taxpayer's employment subsequently transfers the restricted equity instruments to another connected person or a person party to a transaction not at arm's length the tax implications upon vesting of the share will still be for the taxpayer's account.

Therefore the disposal by the taxpayer in these circumstances is a non-vesting event and subsequent vesting in the hands of the other person creates gains (or losses) for the taxpayer.

These provisions however do not apply where a taxpayer disposes of a restricted equity instrument (including by forfeiture, lapse or cancellation) to his or her employer, associated institution or by arrangement with the employer in terms of a restriction imposed for an amount less than market value. The roll-back provisions will also not apply to private companies using

valuation methods which may not accurately reflect the market value of the instruments due to the specific valuation methods used.

3.4.8 The employer

There may be a section 11(a) deduction available to the employer or associated institution with respect to the allocation or issue of shares to employees or upon the vesting of equity instruments in the hands of employees. Please refer to chapter 4 for discussions in this regard.

Donations tax shall not be payable by the employer in terms of section 56(1)(k) on the allocation of shares to employees. The provisions of that section are applicable to section 8A, 8B and 8C instruments and determines that donations tax shall not be payable by the employer company on the value of the shares granted to employees (by virtue of the inclusion of the value of the equity instruments in gross income paragraph (c) in the case of section 8C instruments). Donations tax shall also not be payable on section 8A, 8B and 8C gains made by employees (section 56(1)(k)(ii)).

The employer will be liable for donations tax in terms of section 58(2) in cases where equity instruments are disposed of to a person other than the taxpayer by virtue of the taxpayer's employment or office of director, at the date of vesting at fair market value less consideration received.

The definition of remuneration in the Fourth Schedule includes in paragraph (b) amounts of taxable benefits to be included in paragraph (i) of the gross income definition. Taxable benefits

exclude the value of any equity instrument contemplated in section 8C per paragraph 2 of the Seventh Schedule. As a consequence employees' tax is not deductible by the employer on the value of such shares granted to employees.

The definition of remuneration (paragraph (e)) further includes any gain determined in terms of section 8C and employees' tax must be deducted or withheld by the employer from consideration paid or payable to the employee in respect of the cession, release or disposal of the qualifying equity shares or from any cash remuneration payable to the employee after, to the knowledge of the employer, that share has been disposed of.

Specific provisions relating to the deduction or the withholding of employees' tax apply to section 8C gains and are set out in paragraph 11A of the Fourth Schedule. These provisions apply to sections 8A, 8B and 8C and were discussed under section 8A above.

The employer will not account for CGT on the disposal of section 8C equity instruments to employees before date of vesting, in terms of paragraph 11(2)(j) of the Eighth Schedule. The employer will also not account for CGT on the deemed disposal before date of vesting of section 8C equity instruments by way of donation, for consideration not measurable in money or for a price not reflecting arm's length, in terms of paragraph 38(2)(d).

3.4.9 The employee

The employee must include in income any gain or loss made on the vesting of an equity instrument acquired in terms of section 8C (thus by virtue of employment or by arrangement with the employer). The employer is required to deduct employees' tax from the gains.

The value of the shares received by employees as a result of employment or by arrangement with their employers are included in the gross income of employees by virtue of paragraph (c) of the gross income definition which states that any amount, including any voluntary award, received or accrued in respect of services rendered or any employment shall be included in gross income.

But section 10(1)(nD) exempts from gross income any amount received by or accrued to a person in the form of an equity instrument contemplated in section 8C or consideration for the disposal of such an equity instrument, which has not yet vested. Thus employees are only taxed upon the vesting of equity instruments on gains calculated in accordance with the section 8C rules and not when they acquire or sell such instruments.

The employee will be liable for donations tax in cases where equity instruments are disposed of to connected persons or disposed at a non arm's length price prior to vesting, at the date of vesting at fair market value less consideration received according to section 58(2). Section 56(1)(b) exempts any donation made to the spouse of the donor from donations tax.

In terms of paragraph 11A(6) of the Fourth Schedule the employee has an obligation to inform the employer if he has made a gain in terms of a section 8C transaction to which the employer is not a party. Failure to inform the employer will render the employee guilty of an offence and liable on conviction to a fine not exceeding R2 000.

Equity instruments acquired by an employee as contemplated in section 8C are excluded from the definition of taxable benefit in the Seventh Schedule by virtue of the section 10 exemption as well as in terms of paragraph 2(a)(iv) of the Seventh Schedule and therefore not included in gross income per paragraph (i) of the definition. The acquisition of section 8C shares are thus not seen as assets acquired for no consideration or for consideration less than the value of the asset and are not taxed as fringe benefits.

A loan to an employee for the payment of any consideration for an equity instrument contemplated in section 8C at no interest or at a rate lower than the official rate (of nine per cent since 1 September 2006) will give rise to a taxable benefit in terms of paragraph 2 of the Seventh Schedule.

If an employee ceases to be a resident of the Republic within five years of the date of grant, the shares are not deemed to have been disposed of in terms of paragraph 12(2)(a)(iii) of the Eighth Schedule. Paragraph 12 can thus not be used to trigger an early vesting date in terms of section 8C and so limit the gain to be included in income.

If the employee disposes of the equity instrument after vesting as a capital asset, the equity instrument will upon vesting obtain a base cost equal to market value per paragraph 20(1)(h) of the Eighth Schedule and the capital gain or loss will be the difference between the consideration on date of disposal and the market value on date of vesting.

3.4.10 Discussion points

Possible double taxation of options (Section 8C and CGT)

In a letter to SARS by PricewaterhouseCoopers (Swanepoel, 2005:4-5) it is explained that in cases where an option vests (due to the lifting of all restrictions) before it is exercised a portion of the gain will be taxed twice, once under section 8C and a second time under the CGT rules. This can be illustrated by an example (based on the example in the letter): The taxpayer is granted an option in year 1. All restrictions on exercising the option are lifted in year 3. The taxpayer actually exercises the option in year 5 and sells the shares in year 7.

The option is granted in year 1 at a strike price of R40, a premium of R10 is payable for acquiring the option and the market price of the share at the time is R30. When all restrictions are lifted in year 3 the share price is R75 and the value of the option is for the sake of simplicity the intrinsic value of R35 (R75 less R40). The taxpayer exercises the option in year 5 when the share price is R95 and sells the shares in year 7 for R105.

For the purposes of section 8C the option is seen as an equity instrument per the definition. No tax event occurs in year 1 as the option is still restricted for section 8C purposes. The option will vest in year 3 when all restrictions are lifted (based on the assumption that the underlying

share is not a restricted instrument). The taxpayer will thus account for a gain of $R35 - R10 = R25$ in year 3, which is the market value of the option less the consideration paid.

In year 5 the option is exercised and at this point in my opinion section 8C(1)(b)(i) is applied and there is no tax event. Section 8C(1)(b)(i) states that section 8C shall not apply to equity instruments which was acquired by exercise of any other equity instrument where section 8C was already applied to that equity instrument (the option in this case) before the exercise.

The authors of the letter to SARS puts forward two arguments one for section 8C(1)(b)(i) applying and for it not applying. I am of the opinion that section 8C(1)(b)(i) will apply and therefore only deal with that argument.

When the taxpayer eventually sells the underlying share in year 7 for R105 a capital gain is realised based on the assumption that the share was held on capital account. The gain would be $R105 - (R40 + R10) = R55$, which is the proceeds on the sale of the shares less the base cost calculated by applying the basic CGT rules. The base cost is the sum of the strike price of the option that was paid for the shares plus the premium paid for the option. Paragraph 20(1)(h) of the Eighth Schedule would not apply to deem the market value of the share disposed of to be the base cost because the acquisition or vesting of the share did not give rise to a section 8C gain to be included in income (because the vesting of the option gave rise to a section 8C gain).

In total the taxpayer will account for a gain of $R25 + R55 = R80$ for tax purposes but in reality the taxpayer only made an economic gain of $R105 - R50 = R55$. This is due to the fact that

there are no provisions for taking into account the market value of the option when calculating the base cost of the relating share sold. The calculation that would be equitable should be $R105 - (R40 + R35) = R30$, which is the proceeds on sale of the shares less the base cost consisting of the strike price of the option plus the market value of the option. The R30 plus the R25 gain recognised in year 3 add up to the R55 economic gain that should reasonably be taxable.

I therefore submit that the CGT legislation be amended to state clearly that the market value of an option that was previously subject to section 8C should be taken into account when determining the base cost of the related share when it is disposed of.

According to Ernst & Young (2006b) SARS is of the view that the Eighth Schedule already provides for the incorporation of the market value of the option in the base cost of the share in the following way: Step one is that the market value of the option is deemed to be expenditure actually incurred in respect of acquiring the option per paragraph 20(1)(h) and step two is that the base cost of the share includes expenditure actually incurred in respect of the relating option per paragraph 20(1)(c)(ix). Although this seems to provide an answer to the problem identified SARS acknowledges that it is not obvious from the legislation and proposes to issue an explanatory memorandum. I agree with the view that an explanatory memorandum is needed but in conjunction with an amendment to paragraph 20(1)(h) as suggested earlier.

Subsequent sale of equity instruments on revenue account

In the same letter (Swanepoel, 2005:5-6) the situation is discussed where a taxpayer acquires equity instruments in terms of section 8C on revenue account from the outset (i.e. the taxpayer

is a share dealer) and subsequently sells those shares. The tax results appears to be inequitable as illustrated in the example below (based on the example in the letter):

Assume a taxpayer participating in a share incentive scheme is also a share dealer and thus holds all shares acquired on revenue account. The taxpayer acquires unrestricted shares worth R100 from the share scheme in year 1 for R50. The taxpayer eventually sells the shares so acquired for R200 in year 3.

The shares vest in year 1 at acquisition and a gain of R50 ($R100 - R50$), which is the value of the shares less the consideration paid for the shares, is taxed under section 8C. In year 3 the shares are sold on revenue account. If section 23B(1)(b) applies, to disallow the deduction of an amount that was already taken into account to determine taxable income under another provision of the Act, in other words to disallow the R50 consideration that was taken into account to determine the section 8C gain upon vesting, the income gain would be $R200 - R0 = R200$, being the total amount received not of a capital nature less the expenditure actually incurred in the production of the income not of a capital nature but disallowed by section 23B(1)(b).

On the other hand if section 23B(1)(b) does not apply and a section 11(a) deduction is available the gain would be $R200 - R50 = R150$ of which R50 was already subject to income tax by being included in income under section 8C.

When calculating the CGT charge also in year 3, proceeds will in both situation described above be equal to zero as proceeds are reduced by amounts included in gross income, therefore $R200 - R200 = R0$. The base cost in both situation described above will be calculated in terms of paragraph 20(1)(h) as the market value that was taken into account when the section 8C gain was determined, therefore R100. But the base cost will be reduced by amounts that were allowed in determining taxable income and thus in the situation where section 23B did not apply the base cost will be reduced by the R50 consideration that was taken into account when the section 8C gain was determined.

Therefore where section 23B is applied the capital loss of R100 is incurred, being proceeds of R0 less base cost of R100, and where section 23B is not applied a capital loss of R50 is incurred, being proceeds of R0 less base cost of $R100 - R50 = R50$.

Taking into account these capital losses with the income profits calculated above one seems to reach an equitable economical answer where section 23B is applied but when taking into account that the advantage of the capital losses is at a rate which is much lower (10% effective in the case of an individual taxed at the maximum marginal rate of 40%) than the rate at which the income profits are taxed and assuming that the individual can utilise the CGT loss against other CGT gains, the answer is clearly not equitable.

I therefore submit that legislation should be added to firstly clear up the question of whether section 23B will apply or not. In my opinion, to obtain equitable results, section 23B should apply in situations such as these where a share held on revenue account vests before it is sold

and the vesting gave rise to a section 8C gain. In this example the R50 paid for the share would thus not be allowed to be deducted as expenditure incurred when the share is sold.

It is also submitted that an income tax provision which achieves on revenue account what paragraph 20(1)(h) achieves for CGT purposes be added to current legislation to deem the market value of the share that vested and that was taken into account when the section 8C gain was determined to be allowed as a deduction against income when the share is sold. In this example the R100 (the market value when the shares vested/were acquired) would then be allowed as a deduction against the R200 (the selling price of the shares) giving an equitable gain of R100 plus the earlier gain of R50. Capital losses that arise in situations such as these in other words capital losses for share traders should be disregarded as the shares are not held as capital assets.

Where shares are acquired for no consideration or at consideration not measurable in money section 22(4) applies to deem the cost equal to market value at the date of acquisition. This section will thus not apply where shares are acquired as trading stock at a consideration lower than market value. This section also specifically does not apply to options or other rights to acquire shares. The date of acquisition under section 22(4) may differ from the date of vesting under section 8C which would be the correct date to determine the market value on when compared to paragraph 20(1)(h).

Where an equity instrument is held on capital account initially but is, due to a change of intention, later held on revenue account as trading stock, paragraph 12(2)(c) read with section

22(3)(ii) would have the following effect: CGT will become payable on the difference between the market value at the time of the change of intention and the market value when the section 8C gain was determined upon vesting of the equity instrument. The market value at the time of the change of intention will also become the cost of the equity instrument going forward. The interaction of the market values in this way appears to have equitable tax consequences.

BEE transactions and the interaction with section 8C

In many BEE transactions employers wish to allocate the shareholding to black participants as broadly as possible, which would normally include black individuals of the general public, black owned companies or consortiums as well as the black employees of the company in order to obtain the maximum number of points awarded in the control section of the balanced scorecard. There is a risk that section 8C will apply to shares made available to the black employees of the company and thereby submitting them to less favourable tax treatment compared to black individuals of the general public.

Section 8C seeks to tax a gain (or deduct a loss) on the vesting of an equity instrument that was acquired by the taxpayer “by virtue of his or her employment or office of director of any company or from any person by arrangement with the taxpayer’s employer”.

The terms “by virtue of” was described in *ST v Commissioner of Taxes* 35 SATC 99 by Whitaker P at 100 as:

“Ordinarily the phrase (and this was common cause between counsel) means ‘by force of’, ‘by authority of’, ‘by reason of’, ‘through’ or ‘in pursuance of’. (See Black’s Law Dictionary 4 ed

252.) *Each of these definitions suggests there must be a direct link between the cause and the result.*” (Emphasis added.)

In terms of section 8C this means that there must be a direct link between the employment or holding of office of director and the acquisition of the shares by the taxpayer for the shares or equity instruments to fall within the ambits of section 8C. Even if there is not a sufficient link the shares will still fall within the ambits of section 8C if acquired by the taxpayer from any person by arrangement with the taxpayer’s employer.

In *Stander v Commissioner for Inland Revenue* 59 SATC 212 Stander was an employee of Frank Vos Motors and received a prize in the form of an overseas trip for achieving excellent standards in financial management from Delta Motor Corporation. The question was whether the award or prize fell within the definition of gross income paragraph (c). Paragraph (c) read:

“... or any amount (...) received or accrued *in respect of or by virtue of any employment or holding of office ...*” (Emphasis added.)

Friedman JP held that:

“The fact that Stander was an employee of Frank Vos Motors, was a sine qua non to his receiving the award. Had he not been an employee of a Delta franchise holder he would not have been eligible to receive the award. That fact does not, however, provide the necessary causal link between the services which he rendered to his employer and his obtaining the award. Those services did not constitute the causa causans of the award.” (Emphasis added.)

I therefore submit that for section 8C to apply to black employees participating in a broad based BEE transaction their employment must be the *causa causans* of acquiring the shares and not merely the *sina qua non*. Situations that may point to a direct causal link or a *causa causans* situation include preference given to employees in case of oversubscription to the

shares, a specific number of shares set aside for employees or any other form of favourable treatment given to employees compared to the general public. The courts will look at the wording of communications to staff regarding the BEE transaction, the wording of the prospectus and the intention of directors in this regard to determine whether the necessary causal link exists.

I also submit that the granting of loans to black employees in order to obtain shares in a BEE transaction should not provide sufficient linkage for section 8C to be applied. Fringe benefit tax will however be payable on low interest or no interest loans per the Seventh Schedule.

CHAPTER 4

DEDUCTIBILITY OF EXPENSES

4.1 INTRODUCTION

The IFRS 2 requirement of expensing share based payments in the income statement brought renewed attention to the question of whether a taxpayer can claim a deduction for expenditure (employee costs) settled by way of issuing its own shares or by way of acquiring shares from another party like its holding company in the market to deliver to its employees in terms of a share incentive scheme. The two situations are discussed below.

4.2 SHARES ISSUED

Section 24B of the Act deems a company to have actually incurred expenditure equal to market value when the company has acquired any asset from any person in exchange for shares issued. But this section only applies to assets acquired and not to services acquired.

Where shares are issued to employees in terms of an employee share incentive scheme, in order to retain and motivate staff or to align the interests of senior management closer to that of the company, there are no specific sections of the Act (other than section 11(1A) allowing the market value of a qualifying equity share in terms of section 8B to a maximum of R3,000 per year as a deduction) that allow the employer to deduct the value of the shares issued as an expense for tax purposes. This leads to an inequitable position as the value of the section 8A and 8C shares are taxed in the hands of the employees without a corresponding deduction for the employer.

In situations such as these the taxpayer will look at the general deduction formula in order to obtain a deduction read with section 23 (g), the trade requirement. The general deduction formula as set out in section 11(a) reads as follows:

“For the purposes of determining the taxable income derived by any person from carrying on 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 income, provided such expenditure and losses are not of a capital nature;”

Therefore in order to claim an income tax deduction for shares issued to employees the following requirement must be met:

- Expenditure or losses must be actually incurred;
- In the production of income (not exempt income such as dividends);
- Such expenditure and losses must not be of a capital nature;
- The expenditure or losses must be incurred for the purposes of trade;

The nature of the expense or loss in this case is a cost associated with employment or services rendered because shares are usually issued in order to attract new staff or to retain and award existing staff. Thus the second, third and fourth requirement as set out above should be satisfied fairly easily. The question is therefore whether shares issued to staff can be said to be “expenditure or losses actually incurred”.

Watermeyer AJP stated in *Port Elizabeth Electric Tramway Company Ltd v CIR* 8 SATC 13: *“But expenses actually incurred cannot mean actually paid. So long as the liability to pay them actually has been incurred they may be deductible.”* (Emphasis added.)

This was confirmed in *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste* 1986(3) SA 549(A) and was stated in *Edgars Stores Ltd v CIR* 50 SATC 81 by Corbett JA as follows:

“As my Brother has pointed out, the case hinges on the application of the general deduction formula in s. 11(a) of the Income Tax Act 58 of 1962 – and more particularly the words ‘expenditure . . . actually incurred . . . ’ (Afrikaans text: ‘onkoste . . . werklik . . . aangegaan’) appearing therein. In the recent case of Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste 1986(3) SA 549(A), this court had occasion to consider the meaning of these words in s. 11(a) and at 564A – C Hoexter JA stated the position as follows:

‘Dit is ’n bekende grondstelling dat, vir doeleindes van art 11(a) van Wet 58 van 1962, onkoste werklik aangegaan is in daardie belastingjaar waarin aanspreeklikheid daarvoor regtens ontstaan, en nie (vir geval betaling daarvan later sou plaasvind) in die belastingjaar waarin daadwerklike vereffening van die skuld geskied het nie... Alleen onkoste ten opsigte waarvan die belastingbetaler ’n volstreekte en onvoorwaardelike aanspreeklikheid op die hals gehaal het, mag in die betrokke belastingjaar afgetrek word.’

Thus it is clear that only expenditure (otherwise qualifying for a deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s. 11(a) from income returned for that year.” (Emphasis added)

The above was again confirmed recently in the Pretoria Income Tax Special Court by Jooste AJ in case number 11024 (reported as ITC 1801). In this case the taxpayer purchased a business from another company as a going concern. The taxpayer acquired the business and a trademark and issued shares in order to settle the obligation. The question was whether the taxpayer could claim a deduction in terms of section 11(gA) of the Act relating to the trademark. Section 11(gA) requires that the taxpayer should have actually incurred expenditure in acquiring the trademark.

Paragraph 7 of the decision states that:

“The expression ‘expenditure actually incurred’ means, for purposes of sections such as 11(gA) that the taxpayer should have incurred an unconditional legal obligation in respect of

the amount concerned. It is not required that the obligation should also be discharged." (Emphasis added).

The court also referred to several authorities from England such as a statement by Lord Green MR in *Osborne v Steel Barrel Co Limited* 1942 1 All ER 634 (CA):

"It was strenuously argued on behalf of the Crown that, if a company acquires stock in consideration of the issue of fully-paid shares to the vendor, that stock must, for the purpose of ascertaining the company's profits, be treated as having been acquired for nothing, with the result that, when it comes to be sold, the Revenue is entitled to treat the whole of the purchase price obtained on the sale as a profit. This is a remarkable contention, and it would require conclusive authority before we could accept it. ... The argument really rests on a misconception as to what happens when a company issues shares credited as fully paid for a consideration other than cash. The primary liability of an allottee of shares is to pay for them in cash; but, when shares are allotted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely, the right to call on the allottee for payment of the par value in cash. A company cannot issue £1 000 nominal worth of shares for stock of the market value of £500, since shares cannot be issued at a discount. Accordingly, when fully paid shares are properly issued for a consideration other than cash, the consideration moving from the company must be at least equal in value to the par value of the shares and must be based on an honest estimate by the directors of the value of the assets acquired."

Jooste AJ in the same case (ITC 1801) referred to criticism by Barry Ger in *De Rebus* and D Meyerovitz, SC in *The Taxpayer* of the judgement in a recent Gauteng Tax Court case ITC 1783. In ITC 1783 the court had to decide whether the taxpayer actually incurred expenditure in terms of section 11(a) when he acquired a licence agreement and settled the outstanding obligation by issuing shares as well as whether the expenditure, if incurred, was of a capital nature and whether the property acquired related to rights or know-how acquired.

Goldblatt J in ITC 1783 looked at the ordinary meaning of the word expenditure and held that:

*“That ‘expenditure’ in its ordinary dictionary meaning is the spending of money or its equivalent, e.g. time or labour and a resultant diminution of the assets of the person incurring such expenditure and an allotment or issuing of shares by a company does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders and in these circumstances such issue or allotment of shares does not constitute expenditure by the company and support for this view is to be found in para 7.4 of Silke on South African Income Tax (‘Memorial edition’) ... That, accordingly, **appellant did not establish that it had incurred the alleged expenditure.**” (Emphasis added.)*

Werksmans (2004) made some inquiries into how the situation where a company issues its own shares to meet operating obligations such as salaries or bonuses is treated in countries such as Australia, Canada, New Zealand and the UK and found that in all countries, except Australia, the cost is allowed as a deduction for tax purposes.

I therefore submit that a deduction should be allowed on behalf of companies incurring expenditure in the form of employee costs and settling the expenditure by issuing shares to employees and that the Act should be amended accordingly by inserting a specific section 11 deduction. The reasons for the above submission are as follows:

1. The company should be allowed a deduction for the expense as the corresponding income is taxed in the hands of the employee at the marginal rate in order to achieve an equitable economical result.
2. The basic section 11(a) principles relating to the “expenditure actually incurred” requirement as interpreted by the courts refers to the unconditional legal obligation being incurred and does not look at the method of payment.
3. Overseas countries such as Canada, New Zealand and the UK allow such deductions.

But the uncertainty on the deductibility of expenditure incurred and settled by way of issuing shares will only be clarified if a court, higher than an Income Tax Court, should in future be required to hand down a decision. The fact that the Act has however been drafted to allow a section 11 deduction for section 8B schemes and not for other schemes may indicate the intention of the legislator not to allow such deductions. Therefore even a decision by a higher court allowing such deductions may only lead to an amendment to the Act to specifically disallow such deductions.

4.3 SHARES ACQUIRED

The subject of the deductibility of shares acquired by the employer company in the open market to deliver to its employees for services rendered is similar to the subject of shares issued for services rendered as discussed above. Where for example the employer company purchases shares in its holding company in an open market in order to deliver to employees in terms of a share incentive scheme it should however be much easier to argue that expenditure was actually incurred because money was actually spent.

Practically though, it is not possible for a company to purchase its own shares and deliver them to employees. Section 85 of the Companies Act, 1973 determines that a company may by special resolution of the company approve the acquisition of its own shares but section 58(8) determines that those shares shall be cancelled as issued shares and restored to the status of authorised shares. However if a company incurs expenditure by buying the delivery of shares to employees from a share trust or a third party this problem may be overcome.

Where the employer company purchases shares in its holding company the provisions of sections 39 and 89 of the Companies Act will be applicable. Section 89 determines that a subsidiary company may acquire shares in its holding company to a maximum of 10 per cent of the aggregate number of the issued shares of the holding company. Section 39 determines that the shares held in the holding company shall carry no voting rights.

CHAPTER 5

ACCOUNTING STANDARD IFRS 2

5.1 INTRODUCTION

International Financial Reporting Standard 2: Share-based Payments (“IFRS 2”) issued by the International Accounting Standards Board requires share-based payments to be expensed in the income statement. International Financial Reporting Standards are being adopted as standards of SA GAAP as and when they are issued and therefore IFRS 2 is applicable to all South African registered companies. IFRS 2 is effective for all annual periods beginning on or after 1 January 2005.

The concept of share-based payments for the purposes of IFRS 2 is broader than share-based payments to employees such as employee share incentive schemes; it also encompasses the issuance of shares or rights to shares for services and goods acquired from third parties. For the purposes of this document the focus will be on share-based payments to employees.

5.2 OVERVIEW

IFRS 2 categorises share-based payments as equity-settled, cash-settled or equity-settled with cash alternatives. The amount of expense to be recognised will depend on this categorisation.

The expense should be recognised as the services are consumed by the company. Thus the issuance of fully vested shares is presumed to relate to past service, requiring the full amount of the grant date fair value to be expensed immediately. Conversely, the issuance of shares,

share options or share appreciation rights with vesting periods is considered to relate to services to be provided over the vesting period. The schemes discussed in chapter 2 typically have vesting periods of three to five years.

The expense will be measured at the fair value of the equity instrument granted or the services received, determined at the date of grant. IFRS 2 specifically states that in transactions with employees the expense should be measured at the fair value of the equity instruments granted because it is usually not possible to estimate reliably the fair value of the employees' services.

IFRS 2 requires the fair value to be based on market prices (if available) and take into account the terms and conditions upon which the equity instruments were granted. In the absence of market prices, fair value is estimated using a valuation method to determine what the price of the equity instruments would have been on grant date in an arm's length transaction between knowledgeable, willing parties.

The fair value of share options for which similar traded options do not exist as well as the fair value of share appreciation rights/phantom shares are calculated by applying an option pricing model. Option pricing models take into account as a minimum the following factors: the exercise price, the life span (of the option or share appreciation right), the current price of the underlying share, expected volatility of the share price, expected dividends and the risk-free interest rate. Other factors that knowledgeable, willing market participants would consider should also be taken into account. Non-market vesting conditions and service conditions are not taken into account when determining the fair value at grant date.

IFRS 2 applies to the transfer of an entity's shares by its shareholders to its employees as well as transfers of shares of the entity's parent or another entity in the same group to employees of the entity, unless the transfer is clearly for a purpose other than payment for employment services supplied to the entity. IFRS 2 does not apply to transactions with employees in their capacity as shareholders or holders of equity instruments.

Extensive disclosure of information is required by IFRS 2 to enable users of financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.

5.3 EQUITY-SETTLED SHARE-BASED TRANSACTIONS

Equity-settled share-based payment transactions are transactions in which the entity receives services from employees as consideration for equity instruments of the entity, such as shares and share options. Thus the entity will settle the transaction through the issuance of its own shares directly or through the use of an employee share trust.

The journal entry to recognise these transactions is:

Dr	Expense
	Cr Equity

The fair value of the equity instruments granted is measured at grant date and expensed over the vesting period.

Often share-based payments are conditional on achieving certain performance conditions in addition to future service requirements (per the vesting rules of the share scheme). The expense may vary depending on whether or not the vesting conditions (service or performance) are met. Service conditions and non-market related performance conditions are not taken into account when determining the fair value at grant date.

Service conditions or future service requirements are taken into account by expensing the fair value calculated at grant date over the vesting period. An adjustment is also made for the number of equity instruments expected to vest so that ultimately the amount expensed shall be based on the actual number of shares eventually vesting. Hence, on a cumulative basis, no amount is recognised as an expense if the shares do not vest because the employee fails to complete the specified service period because of, for example, resignation.

Similarly if the scheme's rules specify **non-market related performance conditions** to be achieved (such as earnings per share or revenue growth targets) the grant date fair value excludes these non-market performance conditions and they are taken into account by adjusting the number of shares included in measurement of the transaction amount so that ultimately the amount recognised as an expense shall be based on the actual number of shares eventually vesting.

The number of shares is adjusted based on the best available estimate of the number of shares expected to vest at each reporting date. The length of the vesting period is similarly estimated

by the entity at grant date based on the most likely outcome of the non-market related performance conditions and is revised, if necessary, at each reporting date.

Market conditions are performance conditions where vesting depends on achieving a specific share price of the entity or a specified target share price relative to an index of market prices, for example, the Total Shareholder Return measurement used typically in performance share schemes referred to in chapter 2. These conditions shall be taken into account when estimating the fair value of the shares at grant date and the expense shall be recognised **if all other vesting conditions are satisfied** irrespective of whether the market condition is satisfied. The number of shares included in measurement of the transaction amount is not adjusted subsequently at each reporting date. The length of the expected vesting period at grant date shall be consistent with the assumptions used in estimating the fair value at grant date and shall not be subsequently revised.

If the employee leaves during the vesting period and the service condition is not met, the expense amount recognised to date will be reversed. This is because the service condition, in contrast with the market condition, was not taken into account when estimating the fair value at grant date. Instead the service condition is taken into account by adjusting the transaction amount/expense so that the expense is based on the number of shares that ultimately vest.

In cases where the entity modifies the terms and conditions on which shares were granted, the entity recognises (in addition to what was recognised above) the effects of modifications that increase the total fair value of the transaction. If an entity cancels or settles a grant, the entity

recognises immediately the amount that would have been recognised over the remainder of the vesting period.

Having recognised the expense and a corresponding increase in equity, the entity does not make any subsequent adjustments to total equity after vesting date. Thus if vested shares are later forfeited or vested share options are not exercised the amount recognised will not be reversed. A transfer from one component of equity to another is however allowed.

Please refer to examples B.1 and B.2 in Appendix B showing the accounting treatment of equity-settled share based schemes with non-market and market related performance conditions respectively.

5.4 CASH-SETTLED SHARE-BASED TRANSACTIONS

Cash-settled share-based payment transactions are transactions in which the entity acquires services from employees by incurring liabilities to the employee for amounts that are based on the price of the entity's shares (for example share appreciation rights or phantom shares). Thus the entity will settle the transaction through the payment of cash to employees or other assets such as the purchase of shares of the holding company in the market to deliver to employees.

The journal entry to recognise these transactions is:

Dr	Expense
	Cr Liability

The fair value of the liability is measured at grant date and expensed over the vesting period. Until the liability is settled, the entity remeasures the fair value of the liability at each reporting date and at the date of settlement. Any change in fair value is recognised in profit or loss for the period. A similar distinction is made between market and non-market based performance features as described above. This method of recognition performed at each year-end is also called the “true-up” method.

Please refer to example B.3 in Appendix B showing the accounting treatment of a cash-settled share based scheme.

5.5 SHARE-BASED TRANSACTIONS WITH CASH ALTERNATIVES

Transactions which are share-based with cash alternatives are transactions in which the entity receives or acquires services from employees and the terms of the arrangement provide either the entity or the employee with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing shares.

Phantom share schemes or share appreciation rights schemes will be classified as a share-based transaction with cash alternatives if the employer may choose to settle by issuance of shares or payment of cash or the employee may choose to receive shares or cash upon the vesting of the phantom shares/share appreciation rights.

The journal entry to recognise these transactions is:

Dr Expense

Cr Equity/Liability

The entity accounts for the transactions as a cash-settled share-based payment to the extent that the entity has incurred a liability to settle in cash (or other assets) and as an equity-settled share-based payment to the extent that no such liability has been incurred.

If the employee has the choice of settlement, the entity has granted a compound financial instrument which includes a debt component and an equity component. In such a case the entity shall first measure the fair value of the debt component and then the fair value of the equity component. The fair value of the compound financial instrument is the sum of these fair values. This type of share-based payment transactions are often structured so that the fair value of the one settlement alternative is the same as the other, which will cause the value of the equity component to be zero.

If the entity has the choice of settlement, the entity shall determine whether it has a present obligation to settle in cash and account for the transaction accordingly. The entity has a present obligation to settle in cash if the entity is legally prohibited to issue shares, or has a past practice or stated policy of settling in cash or generally settles in cash. If no such obligation exists, the entity shall account for the transaction as an equity-settled share-based payment.

5.6 ACCOUNTING FOR DEFERRED TAXES

Expenses arising from share-based payments may in certain circumstances be deductible for tax purposes as was discussed in the previous chapter. The amount of the tax deduction may

differ from the accounting expense and the tax deduction may arise in an accounting period that differs from the accounting expense.

If the tax deduction arises in a **later** accounting period, a deductible temporary difference will be accounted for and a deferred tax asset is recognised per IAS 12 Income Taxes.

If the tax deduction arises in an **earlier** accounting period, a taxable temporary difference will be accounted for and a deferred tax liability is recognised. It is not envisaged that many situations will occur (especially in South Africa) where a tax deduction will arise before the recognition of the accounting expense and thus further discussions will focus on deductible temporary differences and relating deferred tax assets.

Deductible temporary differences or deferred tax assets are measured as the difference between the carrying amount of an asset or a liability recognised in the balance sheet and the tax base of the asset or liability. Therefore liabilities recognised under cash-settled share based transactions will have give rise to deferred tax assets calculated as the difference between the carrying amount (the liability on the balance sheet) and the tax base (which is the carrying amount less any amount in respect of that liability that will be deductible for tax purposes in future periods).

In other words the deferred tax asset relating to cash-settled transactions will be the amount that will be deductible for tax purposes in future periods multiplied by 29 per cent. In South Africa a company may receive a section 11(a) deduction in respect of cash-settled share-based

payments where expenditure has been actually incurred and paid out in cash as discussed in chapter 4.

IAS 12 further states that items not recognised as assets (but recognised as expenses) may have a tax base. The tax base of the expense will be an estimate of the future tax deductions. This may apply in equity-settled share based transactions. To date however companies in South Africa have not been allowed a deduction for tax purposes when issuing shares to employees for services rendered except for the section 11(1A) deduction in respect of section 8B (broad-based employee share plans) as discussed in chapter 3.

The deferred tax assets should be remeasured at each balance sheet date based on the entity's current assessment of the tax deduction and recognition of the expense.

If the tax deduction expected to be received is less than or equal to the cumulative expense, the associated tax benefit will be recognised as tax income in the income statement. If the tax deduction expected to be received exceeds the cumulative expense, the excess tax benefit will be recognised directly to equity.

The journal entries will be:

Dr	Deferred Tax Asset
	Cr Income Tax (Income Statement)
	Cr Equity (only the excess if applicable)

In the section 8B case different scenarios may exist. If the entity grants R3,000 worth of shares to the employee in a year, the entity will account for an expense of R3,000 and will receive a tax deduction of R3,000 in the same year. No temporary difference will thus arise. If the entity grants R9,000 worth of shares to the employee in year one (and nothing in year 2 and 3), the entity will account for an expense of R9,000 in year 1 (according to section 8B the employee must receive full voting powers and dividend rights, thus the shares vest immediately) but will receive a tax deduction of R3,000 per year in years 1, 2 and 3. This will give rise to a deductible temporary difference of R1,740 ($R6,000 * 0.29$) at the end of year 1 and R870 ($R3,000 * 0.29$) at the end of year 2.

Many different scenarios may exist for cash-settled share-based transactions. The expense will be recognised over the vesting period but the section 11(a) tax deduction will only be allowed when the expense is actually incurred or the cash is paid out to the employee as case law stands at present. This will give rise to deductible temporary differences and a deferred tax asset will be recognised.

5.7 CONCLUSION

Cash-settled share based payments are marked to market annually at each reporting date (the entity remeasures the fair value of the liability at each reporting date and at the date of settlement) compared to equity-settled share based payments being fair valued once at grant date. Cash-settled payments are revalued and adjustments recognized in the income statement until the instrument is settled compared to equity-settled payments where the expense is recognised until vesting based on the fair value at grant date.

This has the effect that the expense recognised over the vesting period is much more volatile in the case of cash-settled payments and from a time value of money point of view will reflect a higher expense over time in the income statement. Companies therefore prefer to use share schemes that will qualify as equity-based transactions under IFRS 2 for accounting purposes. From a tax point of view however cash-settled transactions looks more likely to have possible tax deductions available to the entities.

CHAPTER 6

OTHER NON-TAXATION RELATED ISSUES

6.1 INTRODUCTION

In this chapter the relative provisions of the Companies Act, Corporate Governance and the JSE Listing Requirements are briefly discussed. Other non-taxation related issues that will also have an impact on the choice and implementation of employee share incentive schemes which do not form part of the scope of this document include: Labour Law considerations, BEE codes and charters, the legal formulation of contracts, trust deeds and scheme rules, administration of schemes, communication to staff, other human resources issues and valuation models used to value share options, shares in unlisted companies and other share price dependent instruments.

6.2 COMPANY LAW

Several sections of the Companies Act, 1973 have an impact on employee share incentive schemes, the most important ones are discussed below.

Section 38 of the Companies Act prohibits a company from providing financial assistance to any person for the purpose of purchasing or subscribing for any shares of the company, or its holding company.

Section 38(2)(b) however offers an exemption to this rule which states that the prohibition does not apply to companies providing financial assistance in accordance with a scheme for the purchase or subscription of its own shares or the shares of its holding company by trustees to

be held for the benefit of the company's employees (which includes salaried directors). This provision caused trusts to be the default vehicles for share incentive schemes in South Africa.

Section 38(2)(c) provides another exemption for companies making loans directly to *bona fide* employees in order to enable those employees to purchase or subscribe for shares in the company or its holding company. These shares must be held by the employees as owners of the shares.

The provisions of section 85 were discussed in chapter 4.3, which described the implications of a transaction where a company buys its own shares.

Section 144A defines the term "employee share scheme" for the purpose of the Companies Act and prescribes the appointment of a compliance officer for such a scheme with certain specific duties.

"Employee share scheme" is defined as a scheme established by a company whereby the company sells its own shares or grants options to its own shares to *bona fide* employees of the company or its subsidiary by means of a trust or otherwise.

A company operating an employee share scheme shall disclose in its annual financial statements the number of specified shares allotted during that financial year. Specified shares are defined as any share, including options on shares, offered to employees in terms of an employee share scheme.

The duties of the compliance officer (who shall be accountable to the directors of the company) include:

- Responsibility for the administration of the scheme;
- Furnishing in writing to any employee who receives an offer of specified shares in terms of an employee share scheme:
 - Full particulars of the nature of the transaction, including the risks arising from it;
 - Information relating to the company, including its latest annual financial statements, the general nature of its business and its profit history over the last three years; and
 - Full particulars of any material changes which take place in respect of any of the above information furnished to the employee;
- Ensure that copies of the documents containing the information referred to above are lodged with the Registrar within 30 days after the employee share scheme has been established;
- Lodge a certificate with the Registrar within 60 days after the end of each financial year to the effect that he or she has complied with the obligations in terms of this section during such year and attach thereto any documents containing particulars of any changes, issued during such year.

It would appear that a share appreciation right scheme or a phantom share scheme falls outside the scope of section 144A of the Companies Act, as a share of the company or an option to a

share of the company is not sold or granted but rather a right linked to the share price of the company. However if the appreciation of the right or phantom share is not paid out in cash but settled in shares, the provisions of section 144A will most probably apply.

The Companies Act does not appear to have any penalty clauses relating to the non submission of the information required to be lodged under section 144A.

6.3 CORPORATE GOVERNANCE

The King Report on Corporate Governance for South Africa, 2002 (King II) is the definitive guidance on corporate governance in South Africa and contains a number of provisions relating to share options and share incentive schemes, mainly applicable to directors, which are briefly discussed below.

Section 2.5 of King II deals with Remuneration and includes the following guidance:

- Full disclosure of directors' remuneration should be made including details of earning, share options, restraint payments and all other benefits.
- Remuneration packages of directors should consist mainly of performance-related remuneration in order to align their interests with the interests of the shareholders.
- Share options may be granted to non-executive directors subject to shareholder approval. It is however preferable that non-executive directors receive shares rather than share options.
- The vesting period of share options should encourage long-term decision making.

- Re-pricing of share options as well as share options issued at a discount should be subject to shareholder approval.
- Full disclosure should be given of all share schemes and incentive schemes.

King II applies to all JSE listed companies, all banks, financial and insurance entities as well as all government and public sector entities. Other companies are encouraged to comply with the principles of the Code. King II became effective to financial year commencing on or after 1 March 2002.

The United Kingdom has had many writings on corporate governance starting with the Cadbury Report in 1992 and including the Greenbury Report on Directors' Remuneration in 1995. The Financial Reporting Council issued its amended Code on Corporate Governance in June 2006 which will become effective from the second quarter of 2007. Earlier adoption is encouraged due to the limited nature of the changes made to the Combined Code issued in July 2003. The Combined Code is applicable to all companies listed in the United Kingdom and contains provisions with wording very much similar to South Africa's King II.

The Combined Code encourages the use of other kinds of long-term incentive schemes over and above the use of share options. It states that shares should not vest or share options should not become exercisable in less than three years. Grants and payouts should be subject to challenging performance criteria reflecting the company's performance relative to comparative companies. Total shareholder return (as discussed in chapter 2.3) is given as an example of a key measure of the company's performance.

6.4 JSE LISTING REQUIREMENTS

Listed companies and their subsidiaries must comply with the JSE Listing Requirements relating to share schemes. Provisions relating to share trusts are set out in schedule 14. The main purpose of the schedule is to put a stop to the use of share schemes for trading purposes.

The schedule 14 requirements include *inter alia* the following provisions:

- Shares may only be purchased by the share trust once participants or a group of participants have been identified.
- Shares may only be sold by the trust once the participant has resigned or is deceased or on behalf of the participant once the rights have vested in the employee.
- The share trust may not hold shares exceeding 20 per cent of the issued share capital of the company.
- Executive directors may not be appointed as trustees. Non-executive directors may only be appointed if they do not benefit from the scheme.

The JSE Listing Requirements also regulate that share schemes must contain the following provisions:

- Categories of persons qualifying to participate in the scheme. Participants must be involved in the business of the company or group.
- The total number of shares allocated to the share scheme.
- The maximum number of shares that may be held by any one individual, usually stated as a per cent of total issued share capital.

- The amount payable by the participant on exercise of an option.
- The formula to determine the purchase price of the share.
- The payment period during which participants must pay for the shares.
- The loan period and terms of loans, if any, given to participants.
- Procedures to be followed upon termination of employment or retirement of participants.
- Details of rights attached to shares such as dividend and voting rights.
- Rights and obligations upon a capital restructuring event such as a capitalisation or rights issue.
- Rights and obligations upon liquidation of the company.

The share scheme must be approved in a general meeting of shareholders and the above provisions may not be amended without prior approval also in a general meeting. The auditors of the company must approve all amendments made. The JSE Listings Committee is also required to approve all share schemes.

CHAPTER 7

CONCLUSION

7.1 INTRODUCTION

The main problem that was examined in this thesis was how employee share incentive schemes are taxed in the hands of employers and employees. This problem was addressed by analysing relevant sections of the Income Tax Act as well as applicable case law.

Other areas that were investigated include the impact of IFRS 2 on employee share incentive schemes, the requirements of the Companies Act, the JSE Listing Requirements and Corporate Governance Guidance.

The research results are summarised below in 7.2 per research objective. In 7.3 the conclusions drawn are set out and in 7.4 areas for further research are discussed.

7.2 SUMMARY OF RESEARCH RESULTS

The first primary objective was to obtain an understanding of the workings of different types of employee share schemes used by companies. In chapter 2 the difference between appreciation and full quantum schemes were described as the value received by the employee being either the net gain from the increase in the market value from grant date to exercise date (in the case of appreciation schemes) or the full value of the share at grant date (in the case of full quantum schemes). The workings of ten different types of schemes were explained and local and international trends in the choice of schemes were analysed showing mainly an increase in

restricted share awards and share appreciation rights schemes and a decline in traditional share option and share purchase schemes up to the 2004 year.

The second, third, sixth and seventh primary objectives were discussed in chapter 3 where sections 8A, 8B and 8C schemes were analysed. The analysis included applicable paragraphs of the Fourth, Seventh and Eighth Schedules relating to employees tax, fringe benefits and capital gains tax. Problems with the legislation were also identified and solutions were offered. The main problems discussed relating to section 8A involved deferred delivery schemes. The problems listed in connection with section 8B included interaction with section 9B, the definition of “qualifying equity shares” and interaction with the BEE Act. Section 8C issues raised include the possible double taxation of option, subsequent sale of equity instruments on revenue account and interaction with BEE transactions.

The fourth and fifth primary objections were discussed in chapter 4. Here it was found that the deductibility of employee related expenses actually incurred but settled in the form of the issue of shares or the purchase of shares for delivery was not yet clear but that indications are that such deductions should be allowed based on the well set out judgement in the Pretoria Income Tax Special Court case number 11024 (reported as ITC 1801). The relevant court cases were examined. The intention of the Legislator was also noted.

Chapter 5 contains a description of the workings of IFRS 2 as required by the first secondary objective. The accounting of cash-settled schemes and equity-settled schemes were explained in detail. Schemes that will qualify as equity-based transaction were found to be preferred to

cash-settled schemes due to the difference in the measurement and recognition of the two types of schemes.

The final secondary objective was to determine the effect of the Companies Act, the JSE Listing Requirements and Corporate Governance Guidance on employee share schemes. Chapter 6 sets out the various requirements. The specific requirements in the Companies Act were dealt with and the non compliance with section 144A of the Companies Act was found not to result in penalties for the company. King II were discussed and compared to the relevant guidance in the UK. Lastly the JSE Listing Requirements applicable to listed companies were summarised.

7.3 CONCLUSIONS

The major conclusions drawn for the research performed in the above chapters is set out below:

1. Internationally the number of share option and share purchase schemes is declining and restricted share award and share appreciation right schemes are increasing. These changes appear to be mainly driven by the recent changes in the accounting standards and more specifically the expensing of share options. Corporate governance considerations emphasising performance-driven share schemes for executives and directors are also influencing this move in the type of share scheme implemented.
2. In South Africa a large number of listed companies have started implementing long term incentive plans, deferred bonus schemes and share appreciation right schemes. This is probably mainly due to the fact that many companies are dual listed in the UK or the US

and are thus following international trend. Other reasons include the recent changes in the tax legislation and accounting standards.

3. Deferred delivery option schemes could be structured in order not to trigger section 8A. Section 8C however now eliminates this past planning opportunity by bringing the gain or the loss into the income of the taxpayer upon vesting of the equity instrument.
4. Section 8A is still applicable to all rights to acquire marketable securities obtained by employees before 26 October 2004. Therefore gains made by the exercise, cession or release of such rights so obtained will still be taxable under section 8A.
5. Section 8A includes gains made by taxpayers on the exercise, cession or release of any right to acquire a marketable security whereas section 8C includes or deducts any gains or losses in respect of the vesting of any equity instrument.
6. In broad terms section 8A and section 8C gains are calculated in a similar fashion being the difference between the market value at the date of exercise, cession or release or vesting respectively and the consideration given by the taxpayer/employee.
7. Section 8A applies to directors, former directors or in respect of services rendered by the taxpayer as an employee to an employer. Section 8C applies to equity instruments acquired by virtue of employment or office of director or by arrangement with the taxpayer's employer.
8. Section 8A and 8C contains similar restructuring roll-over and non arm's length roll-back provisions which postpones the effects of sections 8A and 8C to a later date.
9. Donations tax is not payable on the value of shares granted to employees in terms of sections 8A, 8B and 8C or on gains made by employees in terms of those sections.

10. Detailed provisions regulating the deduction of PAYE for sections 8A, 8B and 8C gains made by employees are set out in the Fourth Schedule.
11. The acquisition of section 8A, 8B and 8C instruments are not seen as assets acquired for no consideration, or for consideration less than market value, by the employee from the employer and therefore no fringe benefit tax is payable in terms of the Seventh Schedule in that regard.
12. Low or no interest loans may give rise to fringe benefit tax in cases where employees acquire section 8A and 8C instruments on credit. Loans given in terms of section 8B schemes will not attract fringe benefit tax in this regards due to a specific exemption.
13. Section 8B schemes are the only schemes offering a tax deduction to employers up to a limit of R3 000 per year in terms of section 11(1A).
14. Broad based employee share plans in terms of section 8B will probably not be used by many companies as certain terms are very limiting especially to medium to large sized companies. Those terms include the R9 000 limit in the market value of shares acquired by employees over a three year period, the fact the no restrictions are allowed except for the inflexible time restriction of at least five years, employees being entitled to full dividends and voting rights and the terms stating that employees already participating in other schemes may not participate in the section 8B schemes.
15. The interaction between section 8C and the Eighth Schedule is complex for example at first glance a gain made where an option vests before it is exercised due to the lifting of all restrictions looks to be taxed twice, once under section 8C and once under CGT. Although the workings of paragraph 20(1)(h) and 20(1)(c)(ix) is said to prevent that from

happening an explanatory memorandum is needed to prevent misinterpretations of the intricate workings of the legislation.

16. Equity instruments acquired under section 8C on revenue account which are subsequently sold are also subject to a type of double taxation as there are no provisions allowing for the market value taxed under section 8C upon vesting of the instrument to be deducted from the income gain made on the subsequent sale of the instrument.
17. Section 8C should not apply to black employees participating in a BEE transaction of the company if sufficient linkage does not exist between the acquisition of the shares by the black employees and their employment such as where no preference is given to black employees above other black individuals.
18. The arguments for deducting expenses incurred and settled by way of issuing shares as set out in ITC 1801 are very strong and should be followed by higher courts. The Act has however been drafted to allow a section 11 deduction for section 8B schemes and not for other schemes which may indicate the intention of the legislator not to allow such deductions. Further developments are keenly awaited.
19. Depending on whether share incentive schemes are settled by way of issuing shares or by way of cash payments based on the growth in shares prices, schemes will be accounted for as either cash-settled share based payments or equity-settled share based payments. Share-based payments with cash alternatives are recognised as cash-settled share based payments to the extent that the entity incurred a liability to settle in cash and as equity-settled to the extent that no such liability was incurred.
20. The effects of cash-settled share based payments on the income statement are more volatile than that of equity-settled share based payments as they are revalued at each

reporting date taking into consideration various factors such as the risk-free interest rate, expected volatility and the current price of the underlying share.

21. A deferred tax asset is recognised to the extent that amounts will be deductible for tax purposes in future periods.
22. The Companies Act requires certain information on share incentive schemes to be lodged with the Registrar annually within 60 days after the end of the financial year. There appears to be no penalty clause for non compliance.
23. Performance-linked share schemes are recommended for executives and directors of companies by King II in SA and the Combined Code in the UK.
24. Employee share schemes are not to be used for trading purposes per the JSE Listing Requirements.

7.4 RECOMMENDATIONS

The main recommendations flowing from the research performed above are:

1. “Approved” employee share incentive schemes

Legislation should be put in place which allows for tax favourable treatment of certain employee share incentive schemes approved by Government. Although this has been done with the introduction of section 8B to the Act, a wider selection of “approved” schemes is needed in order to fit the different needs of companies. This should encourage companies to introduce and continue to make use of employee share schemes which is believed by many to increase productivity which is in turn advantageous to the economy in general. This will also bring South Africa more in line with developed countries such as the US and the UK.

2. Amendments to current Income Tax Legislation and guidelines

It is recommended that an explanatory memorandum or guidelines be issued by SARS explaining the taxation of share incentive schemes as well as the complex interaction between section 8C and the Eighth Schedule. It is further recommended that a subsection be added to section 22 of the Act (similar to paragraph 20(1)(h) of the Eighth Schedule) providing a deduction equal to the market value of an equity instrument which upon vesting resulted in a section 8C gain and that was held on revenue account throughout.

3. Aligning the Income Tax Act with the BEE Act

Companies could more easily fulfil the requirements of the BEE Act relating to the control of the company in a broad based manner as suggested in the Codes of Good Practise if they are encouraged and enticed to bring in their own black employees as BEE shareholders. It is suggested that the Income Tax Act be amended to provide tax incentives for companies using employee share schemes as part of a BEE transaction in order to give real shareholder rights to black employees.

4. Deductibility of expenses incurred and settled by way of issuing shares

Legislation should be amended to provide for a specific section 11 deduction relating to expenses settled by way of issuing shares. This will result in an equitable situation as the gain is taxed in the hands of the employee and the relating expense is deductible in the hands of the employer.

5. Availability of public information on employee share incentive schemes

It is recommended that the Registrar of Companies enforce the provisions of section 144A more strenuously and make the information on share schemes available to the public free of charge. This will lead to greater transparency and understanding of share incentive schemes.

7.5 AREAS FOR FURTHER RESEARCH

The following areas of further research have been identified:

1. Tax concessions given by overseas governments in relation to employee share incentive schemes should be analysed for effectiveness and suitability to the South African environment in order to make recommendations to the South African government.
2. There is a need for recent and accurate data on the use of employee share incentive schemes in South Africa. The information used in this thesis was from a survey released mid 2005 based on 2004 information published by companies. Recent and accurate information will allow for more useful research as reasons can be analysed for recent trends.
3. A model could be built in Visual Basic using a decision tree approach in order to facilitate the process of choosing the most suitable employee share incentive scheme for a particular company.
4. The possibility of providing tax incentives for companies selling shares to BEE parties and including black employees should be further investigated.
5. The effect of valuation models on the accounting for employee share incentive schemes could be further investigated.

- 6. The important elements in the drafting of contracts in relation to employee share incentive schemes should be examined.**

APPENDIX A

**DIAGRAMS SHOWING DIFFERENT SCHEMES AND APPLYING TAX
AND ACCOUNTING TREATMENT**

A.1 TAX TREATMENT OF DIFFERENT SCHEMES

Scheme	Tax treatment					
	Employee				Employer	
	S8A gain	S8C gain	CGT	7 th Schedule	4 th Schedule	Deductibility of expense
Traditional Appreciation Schemes						
- Share purchase (SPS)	No (1)	Yes (2)	Yes (3)	Yes (4)	Yes (5)	No (6)
- Share option (SOS)	Yes (7)	Yes (2)	Yes (3)	No (8)	Yes (5)	No (6)
- Deferred delivery option (DDS)	No (9)	Yes (2)	Yes (3)	No (10)	Yes (5)	No (6)
- Convertible (CS)	No (1)	Yes (2)	Yes (3)	Yes (4)	Yes (5)	No (6)
Full quantum schemes						
- Restricted shares (RSA)	Yes (11)	Yes (2)	Yes (3)	No (12)	Yes (5)	No (6)
- Long-term incentive (LTIP)	Yes (11)	Yes (2)	Yes (3)	No (12)	Yes (5)	No (6)
- Deferred bonus (DBP)	Yes (13)	Yes (2)	Yes (3)	No (12)	Yes (5)	Yes/No (14)
Phantom schemes/SARs	No (15)	Yes (16)	No (17)	No (12)	Yes (5)	Yes/No (18)
Broad based schemes (BSS)	N/A (19)	N/A (19)	Yes (19)	No (20)	Yes (5)	Yes (21)
Foreign schemes	Yes/No (22)					

These schemes can be structured in many different ways to suit the specific circumstances and requirements of the company. Therefore the views taken in the above diagram may not always be one hundred per cent accurate and a careful analysis of the relevant documentation such as the scheme rules and the trust deed is needed to determine the tax consequences in each case.

A.1 Notes:

- (1) – As the employee purchases the shares (or the convertible instruments) at market value on loan account, the consideration given for the marketable security and the market value at the date of exercise will be equal, and no section 8A gain will arise. Section 10(1)(nE) covers the employee from adverse income tax effects should the market value of the share price fall below the purchase price. If properly structured the compulsory conversion of a preference share or a debenture to a share should not trigger a section 8A gain.
- (2) – The employee will be taxed under section 8C upon the vesting of shares/share options (i.e. equity instruments). The definition of equity instruments in section 8C specifically includes financial instruments that are convertible into shares as well as options to acquire shares. The vesting of restricted and unrestricted instruments was described in 3.4.4 above. The gain or loss is calculated as the difference between the market value at the time of vesting and the amount of consideration given or to be given by the employee.
- (3) – The employee will be liable for CGT on the subsequent sale of the shares if the intention was to keep the shares on capital account. If the shares were held on revenue account (i.e. the employee was a share trader) the CGT calculation will exclude

amounts already taken into account in determining the taxable income of the employee and the employee will therefore only be liable for normal income tax.

- (4) – Fringe benefit tax will be payable on the outstanding loan made by the employer to the employee if the loan carries no interest or carries interest at a rate lower than the official rate (of nine per cent since 1 September 2006). The fringe benefit is calculated as the difference between the official interest rate and the actual interest rate paid.
- (5) – The employer is required to deduct PAYE from section 8A and 8C gains. The employer is also required to deduct PAYE from section 8B gains made by employees through the disposal of qualifying equity shares within five years of date of grant.
- (6) – Current SARS practice will not allow a deduction for employee costs settled by way of issuing shares (see discussions in chapter 4). Employee costs relating to share schemes that are settled in cash normally comply with all the section 11(a) deduction requirements and are deductible in the hands of the employer.
- (7) – The gain made by the employee upon the exercise of the option (i.e. the difference between the market value and the consideration paid for the share and/or the option, if any) will be subject to section 8A.
- (8) – The employee does not incur an obligation to pay for shares until he/she exercises the option and thereby acquires the shares. Therefore as a loan is not extended to the employee, the employee incurs no fringe benefit tax on a low or no interest loan. If a loan is extended to the employee at the point when the shares are acquired fringe benefit tax may become payable (refer point (4) above).
- (9) – The deferred delivery option scheme triggers section 8A very early when the option is exercised resulting generally in no gain to be taxed under section 8A. This is because

the gain is calculated as the difference between the market value at date of exercise and the consideration given which is usually equal to or very close to that market value (payable at a later point in time).

- (10) – As delivery of the shares and payment for the shares are deferred to a later date and thus no credit is extended, a low interest or no interest loan does not exist and fringe benefit tax is avoided in that regard. The fact that section 8A tax is payable on the gain (even though the gain would be zero or close to zero) hinders the application of para 2(a) of the Seventh Schedule and the employee will not be deemed to have received a taxable benefit upon the eventual delivery of the shares.
- (11) – As the employer issues shares to the employee without requiring any payment (except for the minimum required by the Companies Act) in recognition for services rendered, the difference between the market value and the consideration given will be taxable under section 8A when the marketable securities are acquired.
- (12) – If the gain is taxed under section 8A or section 8C and no loan is extended, there is no fringe benefit tax payable. If section 8A or 8C does not apply, and the employee acquires an asset for less than market value, fringe benefit tax will be payable.
- (13) – When the employer matches the shares bought and held by the employee for the required period by issuing or delivering an equal number of shares to the employee for no consideration, the difference between the market value and the consideration given will be taxable under section 8A when the marketable securities are acquired.
- (14) – The bonus paid out in cash to the employee should be tax deductible in the hands of the employer under section 11(a). The shares issued to the employee during the matching

stage will not be deductible in the hands of the employer per SARS current practice.

Refer also to point (6) above.

- (15) – As phantom shares and share appreciation rights do not constitute “marketable securities” as defined, section 8A will not apply. Therefore the normal income tax rules will apply (the cash received by the employee will be akin to a bonus). Benefits received by employees in terms of such a scheme will fall within the provisions of paragraph (c) of the gross income definition in section 1. Paragraph (c) includes amounts received or accrued in respect of services rendered or by virtue of employment. Phantom shares and share appreciation rights settled in shares will fall within the definition of “marketable security” and thus section 8A will apply to tax those gains.
- (16) – Phantom shares and share appreciation rights settled in cash will not constitute “equity instruments” as contemplated in section 8C. Therefore the normal income tax rules will apply (the cash received by the employee will be akin to a bonus). Benefits received by employees in terms of such a scheme will fall within the provisions of paragraph (c) of the gross income definition in section 1. Paragraph (c) includes amounts received or accrued in respect of services rendered or by virtue of employment. Phantom shares and share appreciation rights settled in shares will fall within the definition of “equity instruments” and thus section 8C will apply to tax those gains.
- (17) – Phantom scheme and share appreciation rights settled in cash will not be subject to CGT as phantom shares and share appreciation rights does not constitute assets per the definition in the Eighth Schedule as currency or a right to currency are specifically excluded. Phantom shares and share appreciation rights settled in shares will constitute

assets per the definition in the Eighth Schedule and CGT will be payable on the eventual sale of the shares obtained (depending on the intention of the employee as discussed in (3) above.

- (18) – Phantom schemes are usually settled in cash and the employer would therefore qualify for a section 11(a) deduction in the year that the expense is actually incurred. Phantom schemes settled by way of issuing shares will not be deductible in the hands of the employer per SARS current practice. Refer also to point (6) above.
- (19) – Section 8B will tax a gain made by an employee at the marginal rates, if the section 8B shares are sold within a period of five years from the date of grant. Section 8B shares sold after a period of five years will be subject to CGT.
- (20) – Low or no interest loans made to employees in terms of section 8B schemes are specifically exempt from fringe benefit tax (although it is difficult to imagine that such loans would be necessary as only the par value may be paid for section 8B shares).
- (21) – A specific deduction is available to employers in terms of section 11(1A). An amount equal to the market value of any share granted to an employee in terms of section 8B at grant date less any consideration given by the employee up to a maximum of R3 000 per employee in any year of assessment may be deducted.
- (22) – The taxation of a foreign scheme will depend on the type of scheme in operation. The same legislation applicable to local schemes will apply to foreign schemes as far as the resident employers and employees are concerned. Non resident employers will be subject to South African taxation legislation based on the source rules.

A.2 ACCOUNTING TREATMENT OF DIFFERENT SCHEMES

Scheme	Equity-settled	Cash-settled
Traditional Appreciation Schemes		
- Share purchase (SPS)	Yes (1)	Yes (1)
- Share option (SOS)	Yes (1)	Yes (1)
- Deferred delivery option (DDS)	Yes (1)	Yes (1)
- Convertible (CS)	Yes (2)	-
Full quantum schemes		
- Restricted shares (RSA)	Yes (3)	-
- Long-term incentive (LTIP)	Yes (3)	-
- Deferred bonus (DBP)	Yes (4)	-
Phantom schemes/SARs	-	Yes (5)
Broad based schemes (BSS)	Yes (6)	-
Foreign schemes		(7)

A.2 Notes:

- (1) – These schemes are normally settled by issuing shares and therefore accounted for as equity-settled transactions but many companies prefer not to let ownership pass and therefore settles in cash by buying the shares back from the employees after the required holding period. The relevant documentation such as the scheme rules and the trust deed needs to be analysed in each case to determine the correct accounting treatment.
- (2) – Convertible schemes normally require compulsory conversion of the instruments into shares after the required holding period and would therefore be accounted for as equity-settled transactions.

- (3) – These schemes usually entails the issuing of shares to employees after certain holding periods or performance criteria have been met and would therefore be accounted for as equity-settled transactions.
- (4) – The bonus paid to the employee which may to the option of the employee be used to purchase shares in his/her own name will not be regarded as a share-based payment transaction. The shares issued to the employee after the holding period on the matching basis will be accounted for as an equity-settled transaction.
- (5) – Phantom schemes are usually settled in cash and will therefore be accounted for as cash-settled transactions. Phantom schemes settled in shares may be accounted for as cash-settled or equity-settled transactions depending on the level of the company (holding company or subsidiary company) and depending on which company's shares are delivered to employees.
- (6) – Under section 8B schemes employees must acquire full ownership of the shares and will therefore be accounted for as equity-settled transactions.
- (7) – A foreign scheme can take on the form of any of the schemes mentioned and would thus be accounted for accordingly. IFRS 2 applies to the transfer of an entity's shares by its shareholders to its employees as well as transfers of shares of the entity's parent or another entity in the same group to employees of the entity.

APPENDIX B**IFRS 2 EXAMPLES****B.1 EQUITY-SETTLED SHARE-BASED TRANSACTIONS WITH NON-MARKET PERFORMANCE CONDITIONS****B.1.1 BACKGROUND**

The following example is based on “IG Example 2” in the Implementation Guidance to IFRS 2. An entity grants 100 shares to each of its 500 employees at the beginning of year 1. The shares will vest at the end of year 1 if the entity’s earnings increase by more than 18 per cent; at the end of year 2 if the entity’s earnings increase by more than an average of 13 per cent over the two-year period and at the end of year 3 if the entity’s earnings increase by more than an average of 10 per cent over the three-year period. The employee must remain in the entity’s employ during the vesting period. The shares have a fair value of R30 per share at the beginning of year 1, which is equal to the share price at grant date.

By the end of year 1, the entity’s earnings have increased by 14 per cent, 30 employees have left the entity and the share price is R35. The entity expects that earnings will continue to grow at a similar rate in year 2, and therefore expects that the shares will vest at the end of year 2. The entity expects that a further 30 employees will leave the entity’s employ during year 2.

By the end of year 2, the entity’s earnings have increased by 10 per cent, therefore the shares do not vest, 28 employees have left during the year and the share price is R40. The entity

expects that earnings will increase by 6 per cent in year 3, thereby achieving the 10 per cent average, and that a further 25 employees will leave the entity's employ.

By the end of year 3, the entity's earnings had increased by 8 per cent, resulting in an average of 10.67 per cent and 23 employees have left during the year. The share price is R45. Assume also that the entity will get a section 11(a) tax deduction when the shares are issued at the end of year 3 equal to the share price at date of issue. The income tax rate is 29% at all times.

B.1.2 APPLICATION

Year 1:

Dr	Expense	660,000
	Cr	Equity
		660,000

(440 employees x 100 shares x R30 x 1/2)

Dr	Deferred Tax Asset ①	223,300
	Cr	Deferred Tax (Income Statement)②
		191,400
	Cr	Equity③
		31,900

- ① - The deferred tax asset is based on an estimate of the amount that SARS will allow as a deduction in future periods per paragraph 68B, therefore based on the actual share price of R35 (440 employees x 100 shares x R35 x 1/2 x 0.29).
- ② - Deferred tax relating to the cumulative remuneration expense (R660,000 x 0.29).
- ③ - The excess should be recognised directly to equity per paragraph 68C (((440 employees x 100 shares x R35 x 1/2) – R660,000) x 0.29).

Year 2:

Dr	Expense	174,000
	Cr	Equity
		174,000

(417 employees x 100 shares x R30 x 2/3) – R660,000

Dr	Deferred Tax Asset ^①	99,180
	Cr	Income Tax (Income Statement) ^②
		50,460
	Cr	Equity ^③
		48,720

① - (417 employees x 100 shares x R40 x 2/3 x 0.29) – R223,300

② - R174,000 x 0.29

③ - (((417 employees x 100 shares x R40 x 2/3) – (R660,000 + R174,000)) x 0.29) – R31,900

Year 3:

Dr	Expense	423,000
	Cr	Equity
		423,000

(419 employees x 100 shares x R30 x 3/3) – (R660,000 + R174,000)

Dr	Deferred Tax Asset ^①	224,315
	Cr	Income Tax (Income Statement) ^②
		122,670
	Cr	Equity ^③
		101,645

① - (419 employees x 100 shares x R45 x 3/3 x 0.29) – (R223,300 + R99,180)

② - R423,000 x 0.29

③ - (((419 employees x 100 shares x R45 x 3/3) – (R660,000 + R174,000 + R423,000)) x 0.29) – (R31,900 + R48,720)

Dr	Income Tax (Income Statement)	364,530	
Dr	Equity	182,265	
	Cr	Deferred Tax Asset	546,795

(Reversal of deferred tax at end of year 3)

There are no further accounting entries after vesting date for equity-settled transactions.

B.2 EQUITY-SETTLED SHARE-BASED TRANSACTIONS WITH MARKET RELATED PERFORMANCE CONDITIONS

B.2.1 BACKGROUND

The following example is based on “IG Example 5” in the Implementation Guidance to IFRS 2. A company grants to a senior executive 10,000 share options at the beginning of year 1 on the condition that the executive remains an employee of the company until the end of year 3. Further vesting conditions are that the share options cannot be executed unless the share price has increased from R50 at the beginning of year 1 to above R65 at the end of year 3. If the share price reaches the target share price by the end of year 3 the share options can be exercised at any time during the next seven years.

The company applies the Bermudan binomial option pricing model, which takes into account the possibility that the share price will exceed R65 at the end of year 3 and the possibility that the share price will not exceed R65 at the end of year 3 and estimates the fair value at grant date to be R24 per option. Assume also that the entity will not get any tax deductions when the shares are issued upon exercise of the options.

B.2.2 APPLICATION

Year 1:

Dr	Expense	80,000
	Cr	Equity
		80,000

(10,000 options x R24 x 1/3)

Year 2:

Dr	Expense	80,000	
	Cr	Equity	80,000

(10,000 options x R24 x 2/3) – R80,000

Year 3:

Dr	Expense	80,000	
	Cr	Equity	80,000

(10,000 options x R24 x 3/3) – R160,000

These amounts are recognised irrespective of the outcome of the market condition. However, if the executive left during year 2, the amount recognised during year 1 would be reversed in year 2. This is because service conditions, in contrast with the market conditions, are not taken into account when estimating the fair value of the share options at grant date. Instead service conditions are taken into account by adjusting the transaction amount in order to reflect the number of shares that ultimately vest.

No provision is made for deferred tax as tax deductions will not be available to the company in future periods and therefore the tax base and the carrying amount are both nil at any of the recognition dates.

B.3 CASH-SETTLED SHARE-BASED TRANSACTIONS

B.3.1 BACKGROUND

The following example is based on “IG Example 12” in the Implementation Guidance to IFRS

2. At the beginning of year 1, an entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees, on condition that the employees do not leave the entity’s employ within the next three years.

35 employees leave the entity during year 1. At the end of year 1 the entity estimates that a further 60 employees will leave during year 2 and 3. 40 employees actually leave the entity during year 2 and at that point in time the entity estimates that a further 25 employees will leave during year 3. 22 employees actually leave the entity during year 3.

150 employees cash-in their SARs at the end of year 3, 140 employees cash-in at the end of year 4 and the remaining 113 employees cash-in at the end of year 5.

The estimated fair values as well as the intrinsic values (the growth in value of the SARs paid out in cash) of the SARs at each year-end are as follows:

Year	Fair value	Intrinsic value
1	R14.40	-
2	R15.50	-
3	R18.20	R15.00
4	R21.40	R20.00
5	-	R25.00

Also assume that the entity will receive a section 11(a) tax deduction of the amounts actually paid out to employees in the year which the payment is made. The income tax rate is 29% at all times.

B.3.2 APPLICATION

Year 1:

Dr	Expense	194,400
	Cr	Liability
		194,400

Recognise expense at fair value $((500 - (35 + 60))$ employees \times 100 SARs \times R14.40 \times 1/3)

Dr	Deferred Tax Asset	56,376
	Cr	Deferred Tax (Income Statement)
		56,376

$(R194,400 \times 0.29)$

Year 2:

Dr	Expense	218,933
	Cr	Liability
		218,933

Recognise expense at fair value $((500 - (75 + 25))$ employees \times 100 SARs \times R15.50 \times 2/3) –
R194,400

Dr	Deferred Tax Asset	63,491	
	Cr	Deferred Tax (Income Statement)	63,491

(R218,933 x 0.29)

Year 3:

Dr	Expense	47,127	
	Cr	Liability	47,127

Recognise expense at fair value and reverse the first portion, the net effect is shown here ((500 – 97 – 150 = 253) employees x 100 SARs x R18.20 x 3/3) – R194,400 – R218,933

Dr	Deferred Tax Asset	13,667	
	Cr	Deferred Tax (Income Statement)	13,667

(R47,127 x 0.29)

Dr	Expense	225,000	
	Cr	Bank	225,000

Recognise actual expense (150 employees x 100 SARs x R15.00)

Year 4:

Dr	Liability	218,640	
	Cr	Expense	218,640

Reversal of expense at fair value (R194,400 + R218,933 + R47,127) – ((253 – 140) employees x 100 SARs x R21.40)

Dr	Deferred Tax (Income Statement)	63,406
	Cr	Deferred Tax Asset
		63,406

(R218,640 x 0.29)

Dr	Expense	280,000
	Cr	Bank
		280,000

Recognise actual expense (140 employees x 100 SARs x R20.00)

Year 5:

Dr	Liability	241,820
	Cr	Expense
		241,820

Reversal of expense at fair value ((R194,400 + R218,933 + R47,127) – R218,640)

Dr	Deferred Tax (Income Statement)	70,128
	Cr	Deferred Tax Asset
		70,128

(R241,820 x 0.29)

Dr	Expense	282,500
	Cr	Bank
		282,500

Recognise actual expense (113 employees x 100 SARs x R25.00)

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