Anti-avoidance, amendments and anomalies: The impact of select anti-avoidance provisions and their subsequent amendments on employee share incentive schemes operating through trusts.

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ABSTRACT

Employee share incentive schemes have become a common phenomenon in companies world-wide and are an established method of allowing the employee to hold equity in the company which in turn allows the employee to personally benefit from the growth and profitability of the company. In light of the fact that employees receive remuneration by virtue of their employment and through their participation in these employee share schemes, the tax treatment of this remuneration should be considered in terms of the South African taxation laws.

The Income Tax Act 58 of 1962 has been amended over time so as to introduce various anti-avoidance rules aimed at preventing employee participants in these schemes from classifying income received by virtue of employment as either dividends or capital gains. These anti-avoidance provisions, contained in sections 8C and 10(1)(k)(i) and the Eighth Schedule to the ITA, have evolved since their introduction, so as to:

1. address any anomalies and to close perceived loopholes identified in terms of these provisions; and
2. to clarify the circumstances in which these provisions will find application.

This study highlights the evolution of these anti-avoidance provisions and discusses (a) whether the amendments succeeded in addressing the anomalies and closing loopholes as intended; and (b) whether the amendments inadvertently created any additional anomalies.

An analysis of the current wording of the anti-avoidance provisions is conducted and the impact these provisions on the most prevalent employee share schemes operating through trusts is explored, whereafter suggestions for further amendments to the ITA are proposed.

TABLE OF ABBREVIATIONS

Abbreviation	Meaning
BBBEE	Broad-based Black Economic Empowerment
CGT	Capital Gains Tax
ITA	Income Tax Act 58 of 1962
SAR	Share appreciation right
SARS	South African Revenue Service
SIT	Share incentive trust
STC	Secondary Tax on Companies

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Chapter 1: Introduction

"Taxes are the lifeblood of government and no taxpayer should be permitted to escape the payment of his just share of the burden of contributing thereto."
– Arthur Vanderbilt

1.1 Background

Employee share incentive schemes have become a common phenomenon in companies world-wide. These schemes are popular mechanisms through which employees are awarded remuneration that is equity-based.[1] South Africa is no exception, as is evidenced from the sheer number of listed South African companies' annual reports disclosing some form of employee share incentive scheme.[2]

Various employee share incentive schemes can be found in the South African market. Employee share incentive schemes are typically aimed at one of two categories of employees, namely (a) senior management and / or executive directors of a company, and (b) schemes in terms of which all employees are eligible to participate. The operation of each scheme depends on a variety of factors, such whether the company is listed or unlisted, whether the scheme is an equity-settled or cash-settled scheme, and whether the scheme is administrated by way of a trust.

The rationale behind the design and implementation of the schemes differ, but generally the purpose of these schemes are:[3]

[1] Global Equity Insights 2015, accessed on 3 March 2018, https://www.equatex.com/wp-content/uploads/GEO_Report_2015_Equatex_web.pdf?x93601.
[2] Employee share incentive schemes are not limited to companies operating in a listed environment, but extend to private companies as well. Given the lack of public disclosure of private company data, the observations herein are predominantly drawn from studying the integrated annual reports of listed companies.
[3] Samantha Jonas, "A Critical Analysis of the Tax Efficiency of Share Incentive Schemes in Relation to Employees In South Africa," (MCom Taxation thesis, University of Stellenbosch, 2012), 12 – 14.

1. To align the interests of employees with those of the stakeholders of the company by providing the employee with a form of equity-based remuneration.[4] This ensures that the employee's remuneration is linked to the company's share price, which in turn encourages share price growth;
2. To attract, retain and motivate employees to deliver their company's business strategy;[5] and
3. To encourage ownership in the company through participation in a broad-based equity plan.[6]

In light of the fact that employees may effectively receive remuneration by virtue of both their employment and through their participation in these employee share schemes, the tax treatment of these schemes must be carefully considered in order to prevent the re-characterisation of remuneration as capital gains or exempt dividends.

The Income Tax Act 58 of 1962 (hereafter referred to as "the ITA") currently deals with the taxation of equity instruments acquired by virtue of an employee's employment in section 8C. Section 8C applies notwithstanding sections 9C[7] and 23(m)[8] of the ITA and places the obligation on taxpayers to include in their gross income[9] for the year of assessment[10] any gain or loss with regards to the vesting of an equity instrument[11] acquired by the taxpayer[12] by virtue of his employment or office as director.

Historically, employee share incentive schemes were often designed and operated in such a manner as to allow the income received in terms of these schemes to be classified

[4] Paul Oyer & Scott Schaefer, "Why do some firms give stock options to all employees?: An empirical examination of alternative theories," *Journal of Financial Economics,* 76 (2005):100 and Jonas, 13.
[5] Takalani Philip Nyelisani, "Employee perceptions of share schemes,*"* (MBA thesis, University of Pretoria, 2010), 20 and Jonas, 13-14.
[6] Jonas, 13-14.
[7] Section 9C deems an equity share which was held for a period of more than three years before its disposal to be of a capital nature. As section 8C overrides this provision, this means that section 8C will apply in the event where an equity share vests after a period of three years and that gain arising upon the disposal of the equity share will be taxable as income.
[8] This provision prohibits the deduction of expenditure, loss or allowance which relates to employment or office held in respect of which remuneration is earned. As section 8C overrides this provision, it means that losses remain deductible in respect of the section 8C equity instruments.
[9] Defined in section 1 of the ITA.
[10] Defined in section 1 of the ITA.
[11] Defined in section 8C(7) of the ITA.
[12] Defined in section 1 of the ITA.

as either exempt dividend income or as a capital gain.[13] This resulted in the participants to the schemes being taxed at a lower rate than if such income was received as remuneration. In light of this trend, the ITA underwent various amendments[14] over the past decade so as to introduce anti-avoidance rules aimed at preventing employees from classifying income received by virtue of employment as either dividends or capital gains.

The above-mentioned anti-avoidance provisions, contained in section 8C, section 10(1)(k)(i) and the Eighth Schedule to the ITA, have been evolving since their introduction so as to:

1. address any anomalies and to close perceived loopholes identified in terms of these provisions; and
2. to clarify the circumstances when these provisions will find application.

1.2 Rationale for the research

Over the past decade, anti-avoidance measures were introduced into the ITA to specifically regulate the tax consequences of employee share incentive schemes, particularly those operating through South African resident share incentive trusts (hereafter referred to as "SITs"). Employee share incentive schemes had developed following the introduction of section 8C so as to avoid the application of section 8C on technical grounds. Specifically, a number of schemes had evolved so as to utilise SITs as vehicles in which shares were held and in which a participant did not obtain a right to the actual underlying shares, but rather a right to the value of the shares held in the SIT.

The anti-avoidance provisions impacting on employee share incentive schemes operating through SITs as contained in section 8C, section 10(1)(k)(i) and the Eighth Schedule to the ITA have been a particular focus of National Treasury over the past decade as is evidenced by various Revenue and Taxation Laws Amendment Acts[15] and the

[13] J Kotze "Tax update 2017*"* http://www.wylie.co.za/wp-content/uploads/Tax-Update-2017-Third-Q-.pdf (accessed 1 March 2018).
[14] See Revenue Laws Amendment Act 32 of 2004; Revenue Laws Amendment Act 20 of 2006, Revenue Laws Amendment Act 60 of 2008; Taxation Laws Amendment Act 7 of 2010; Taxation Laws Amendment Act 24 of 2011; Taxation Laws Amendment Act 22 of 2012; Taxation Laws Amendment Act 31 of 2013; Taxation Laws Amendment Act 25 of 2015; Taxation Laws Amendment Act 15 of 2016; Taxation Laws Amendment Act 17 of 2017.
[15] Ibid.

accompanying Explanatory Memoranda. In particular, the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017 explains that, over the past few years, amendments were made to the ITA to refine these anti-avoidance provisions and to address several unintended anomalies, including the anomaly that the disposal of an equity instrument by a trust to a qualifying participant constitutes a non-event for capital gains tax ("CGT") purposes in terms of the Eighth Schedule.[16] Several provisions of the ITA were clarified so as to defer the recognition of the capital gain in the trust when it disposes of shares to a participant in terms of the scheme, until the equity instruments become unrestricted and vests for purposes of section 8C.[17]

The amendments included changes to the Eighth Schedule which stated that, where the trust disposes of shares and vests the proceeds in the hands of the qualifying participant,[18] then the provisions of paragraph 80(2) will not apply if such amount is to be taken into account in the hands of the qualifying participant for purposes of section 8C of the ITA.[19]

In light of the amendments to these anti-avoidance provisions (particularly those addressing employee share incentive schemes operating through SITs), and the effects of these amendments on participants of employee share incentive schemes, a detailed analysis of those amendments is beneficial in order to understand:

1. the effects of these amendments on participants to these schemes, in particular:

    a) the treatment of dividends received by participants from SITs on restricted equity instruments; and

[16] Refer to National Treasury "Explanatory Memorandum to the Taxation Laws Amendment Bill 2015," 10, accessed on 4 April 2018, http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2015-01%20-20Explanatory%20Memorandum%20on%20the%20TLA%20Bill%2029%20of%202015.pdf and the Taxation Laws Amendment Act 25 of 2015 at section 123; and the Taxation Laws Amendment Act 17 of 2017 which amendment paragraphs 80(1), 80(2), 80(2A) and 64E of the Eighth Schedule. See also section 13(1) of Taxation Laws Amendment Act 15 of 2016 which amended section 8C(1A).
[17] Defined in section 1 of the ITA.
[18] For purposes of clarity, "participant" refers to employees who participate in employee share incentive schemes operating through trusts by virtue of their employment. Where appropriate, these employees may also be referred to as "employee beneficiaries" or "employees".
[19] National Treasury "Explanatory Memorandum to the Taxation Laws Amendment Bill 2017,"10, accessed on 5 April 2018, http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2017-01%20-%20Explanatory%20Memorandum%20on%20the%202017%20Taxation%20Laws%20Amendment%20Bill%2015%20December%202017.pdf.

b) the CGT treatment on the disposal of shares held by SITs, as well as the CGT treatment of the vesting and distribution of shares or gains derived from the disposal of shares, to participants of the SIT.

2. whether these amendments addressed the inconsistencies and anomalies created by previous amendments to the ITA; and
3. whether further inconsistencies and anomalies provisions may inadvertently have been caused by these amendments to the ITA.

The author accordingly formulated three key research objectives which are set out below.

1.3 Research objectives and value of research

This dissertation is aimed at achieving the following research objectives:

1. Considering the most prevalent employee share incentive schemes in South Africa, with a focus on schemes which utilise SITs, in order to provide the necessary context for the discussions in chapters 3 and 4 with regards to the anti-avoidance provisions in section 8C, section 10(1)(k)(i) and the Eighth Schedule which impact on employee share incentive schemes operating through SITs.
2. Exploring the development of these anti-avoidance provisions impacting on employee share incentive schemes operating through SITs over the last decade, with a focus on identifying anomalies created by and/or addressed by amendments to these provisions.
3. Conducting an analysis of the perceived anomalies that still persist in relation to the CGT implications of employee share incentive schemes operating through SITs, including recommendations of possible amendments which could be made to the anti-avoidance provisions in the Eighth Schedule to address these anomalies.

The author has identified two anomalies arising from the current wording of the anti-avoidance provisions in the Eighth Schedule and which impact on employee share incentive schemes operating through SITs. Apart from a comment contained in the Final Response Document on Taxation Laws Amendment Bill, 2017 and Tax Administration

Bill, 2017[20] suggesting an amendment to the wording of paragraph 80(1) and paragraph 64E of the Eighth Schedule, no other academic writings, books or government publications have been identified which highlight these anomalies or offer suggestions for addressing these anomalies. This dissertation aims to fill this gap by highlighting the perceived anomalies negatively impacting on employee share incentive schemes operating through SITs which result from the current wording of the anti-avoidance provisions in the Eighth Schedule; and by recommending possible amendments which National Treasury could consider and which may address the anomalies that persist.

1.4 Research methodology

The research methodology employed in this dissertation is doctrinal research. The research consists of a systematic exploration of the anti-avoidance provisions impacting upon employee share incentive schemes operating through trusts, as well as the common employee share incentive schemes operating through trusts. A critical and systematic analysis of these anti-avoidance provisions is conducted through which the purpose of and interaction between these provisions is highlighted. The research evaluates the adequacy of the anti-avoidance provisions and exposes two anomalies which currently impact upon employee share incentive schemes operating through trusts. Finally, recommendations are offered in respect to addressing these anomalies.

1.5 Structure of the dissertation

This dissertation consists of five chapters. A brief description of the contents of each of the following chapters is set out below:

Chapter 2: Common structures of employee share incentive schemes run through trusts

This chapter considers the most prevalent employee share incentive schemes in South Africa, with a focus on schemes which utilise share incentive trusts ("SITs"), in order to provide the necessary context for the discussions in chapters 3 and 4 with regards to the

[20] National Treasury, *Final Response Document on Taxation Laws Amendment Bill, 2017 and Tax Administration Laws Amendment Bill, 2017, paragraph 2.3 on 12,* accessed 8 April 2018, http://www.sars.gov.za/AllDocs/LegalDoclib/RespDocs/LAPD-LPrep-Resp-2017-06%20-%20Final%20Response%20Document%202017%20TLAB%20and%20TALAB%2015%20December%202017.pdf

anti-avoidance provisions in section 8C, section 10(1)(k)(i) and the Eighth Schedule which impact on employee share incentive schemes operating through SITs. It sets out the most prevalent employee share schemes found in the South African market which typically utilises a SIT. A brief history and the rationale behind the structure and implementation of these schemes is discussed and the salient features and workings of each scheme is set out.

Chapter 3: Anti-avoidance provisions impacting on employee share incentive schemes run through trusts

Chapter 3 aims to explore the development of the anti-avoidance provisions in section 8C, section 10(1)(k)(i) and the Eighth Schedule impacting on employee share incentive schemes operating through SITs over the last decade, with a focus on identifying anomalies created by and/or addressed by the amendments to these provisions. It sets out the history and original purpose behind the implementation of these key anti-avoidance provisions which impact on the tax consequences of employee share incentive schemes operating through SITs. The significant amendments to these provisions over the past decade is further explored. This chapter also sets out the implication of the wording of the current anti-avoidance provisions in section 8C and section 10(1)(k)(i) as they stand on the employee share incentive schemes as set out in Chapter 2. Comments on the effectiveness of these anti-avoidance provisions in achieving the purpose for which they were implemented are included. This chapter further identifies anomalies created by the amendments to the anti-avoidance provisions in order to provide the context required to understand the discussion in Chapter 4 in respect of the perceived anomalies which still persist in relation to the CGT implications of employee share incentive schemes operating through SITs.

Chapter 4: Current anti-avoidance provisions of the Eighth Schedule: Do anomalies remain and how could these anomalies be addressed?

This chapter is aimed at conducting an analysis of the perceived anomalies that still persist in relation to the CGT implications of employee share incentive schemes operating through SITs, including recommendations of possible amendments which could be made to the anti-avoidance provisions in the Eighth Schedule to address these anomalies.

It sets out an analysis of the current wording of paragraphs 80(1), 80(2) and 64E of the Eighth Schedule and includes comments on the effectiveness of these provisions in achieving the aim for which they were implemented. The implications of these provisions for common employee share incentive scheme operating through SITs are examined by way of a case study in order to illustrate how participants under such schemes will be taxed. Recommendations on addressing these anomalies are offered.

Chapter 5: Conclusion

This chapter draws together the findings of the study as well as its relevance and sets out how the research objectives were achieved. Recommendations are set out / emphasised in this chapter and areas for further analysis are also identified.

1.6 Limitations of Scope

The scope of this study is limited to employee share incentive schemes which are operated through using a South African resident SITs as the amendments to section 8C, section 10(1)(k)(i) and the Eight Schedule over the past decade are predominantly anti-avoidance provisions impacting on employee share incentive schemes operating through trusts. Chapter 2 sets out the common structures and workings of employee share incentive schemes operated through SITs which are found in South Africa and which are impacted by the changes to the anti-avoidance provisions as set out in the ITA. Given that employee share incentive schemes are tailored from their inception to fit the requirements and profile of the company and employees for whom the scheme is intended, variations of these schemes can be found in the South African market. As such, the list of schemes discussed is by no means meant to be exhaustive, but is rather aimed at highlighting the salient features of the most commonly used schemes and illustrating the effects of the amendments to the ITA on these schemes.

This study does not differentiate between executive share plans and all-employee share plans using trusts, as both types of schemes are treated in a similar manner for income tax purposes. Broad-based schemes which meet the requirements of section 8B of the ITA are excluded from this study, given that these schemes are rarely found in practice.

In addition to the above, it should be noted that, unless otherwise indicated, no distinction is drawn between employee share incentive schemes operated in a listed company environment and schemes operated in private companies. Although there are differences between schemes operated in a listed environment and those operating in a private environment, these schemes do not differ for the purposes of the anti-avoidance provisions as contained in the ITA. The same rationale applies to the tax treatment of schemes run for the benefit of executives and schemes run for the benefit of all employees.

The aim of this dissertation is not to explore the tax treatment of the various employee share schemes or how participants to these schemes are taxed in detail, as significant research has already been undertaken in this area.[21] As such, the exploration of the evolution of the provisions contained in s8C is limited to the original purpose of this section and the specific anti-avoidance provisions which impact employee share schemes operated through trusts.

The retrospective application, if any, of amendments to the ITA is not discussed in this dissertation but is rather highlighted as an area of future study.

Finally, the scope of this study is limited to the anti-avoidance provisions (and their respective amendments) which prevent the characterisation of income as either a capital gain[22] or a dividend[23] and which impact upon employee share incentive schemes operating through trusts. As the Taxation Laws Amendment Bill 2018 introduced in July 2018 is still in draft, the focus of the study is limited to the anti-avoidance provisions as they currently read in the ITA and the proposed amendments are only touched on briefly in Chapter 4.

[21] See Elriette Esme Butler "Employee Share Incentive Schemes- The taxation of the old and the 'new'" (H.Dip (Taxation) Technical Report, University of Cape Town 2005); and Louise Mercia Bezuidenhout "Employee share incentive schemes: an integrated approach." (MComm thesis, University of Cape Town 2006).

[22] The provisions focused on preventing income as being disguised as a capital gain are contained within section 8C and paragraphs 64E, 80(1) and 80(2) of the Eighth Schedule and must be read together. Refer to the discussions in Chapters 3 and 4 below.

[23] The provisions which prevent income as being disguised as dividends are set out in section 10(1)(k)(i)(dd), (ii), (jj) and (kk). These provisions must also be read with the provisions in section 8C.

In light of the above background, and in order to fully understand the impact of the amendments to the anti-avoidance provisions as contained in the ITA and which are the focus of this study, one must commence by setting out and understanding the history and intention behind these provisions. This is dealt with in the following chapter.

Chapter 2: Common employee share incentive schemes

2.1 Introduction

Employee share incentive schemes are common in South African companies.[24] Share incentive schemes aimed at the remuneration of executives and employees were originally introduced as a mechanism through which companies attempted to counter the high levels of individual taxes.[25] It has, however, become evident that share incentive schemes have an added bonus of acting as a retention mechanism as well as a way in which to drive company performance.[26]

Over the years, different types of schemes have developed so as to address the various needs of companies and to mitigate the changes in income tax legislation[27] impacting upon the operation of these schemes.[28] A number of studies have been conducted over the past decade with regards to the taxation of the different types of share incentive schemes prevalent in the South African market.

This chapter considers the most prevalent employee share incentive schemes in South Africa, with a focus on schemes which utilise share incentive trusts ("SITs"), in order to provide the necessary context for the discussions in chapters 3 and 4 with regards to the anti-avoidance provisions in section 8C, section 10(1)(k)(i) and the Eighth Schedule which impact on employee share incentive schemes operating through SITs.

This is done by exploring the rationale behind companies adopting share incentive schemes; the key variable features of employee share incentive schemes; as well as setting out the salient features of the most prevalent employee share incentive schemes

[24] Allon Joel Isaacman, "Is tax legislation effectively discouraging employee share ownership?" MCom thesis, University of Witwatersrand, 2017, 11.
[25] M Stafford, "The transition in the nature of tax consequences associated with share incentive schemes in South Africa," LLM thesis, University of Witwatersrand, 2005.
[26] Global Equity Insights 2017, 3 and 9; Isaacman, 21; Jonas, 32.
[27] Refer to the discussion in chapter 3 on the various changes to the ITA impacting upon such schemes.
[28] Isaacman, 11; Jonas, 16.

which typically make use of a SIT: share purchase schemes, share option schemes, deferred delivery schemes and phantom share schemes.[29]

2.2 Motivation for the implementation of employee share incentive schemes

There are numerous reasons for companies to consider and implement an employee share incentive scheme. Each company will have its own set of unique circumstances which drives the motivation of the adoption of a particular employee share incentive plan.

The section below sets out the most prevalent reasons for the adoption of share schemes.[30]

2.2.1 Alignment with shareholder interests & motivation

Research indicates that the interests of the employees of a company, specifically the company management is not always aligned to that of the company's stakeholders. Adam Smith, in his well-known work "The Wealth of Nations"[31] makes the following astute observation:

> *"The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore must always prevail, more or less, in the management of the affairs of such a company."*[32]

Jensen and Meckling deem the relationship between the shareholders of a company and the managers of the company to be that of an agency relationship.[33] As such, the misalignment of the interests of shareholders and employees is known as agency theory.

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[29] Isaacman, 11; Butler, 12-18; Bezuidenhout, 11-22; Nicholas Lock, "Dividend payments from employee share incentive trusts," MCom thesis, University of Cape Town, 2017, 13-15.
[30] Global Equity Insights, 2017, 3 and 9; Jonas, 12; Bezuidenhout, 3.
[31] Adam Smith, *An Inquiry into the Nature and Causes of Wealth of Nations,* (London, 1852).
[32] Ibid, 311.
[33] Michael C Jensen and William H Meckling, "Theory of the Firm: Managerial Behaviour Agency Costs and Ownership Structure," *Journal of Financial Economics,* 3 (1976): 309.

Although directors of a company have a legal duty in terms of the Companies Act 71 of 2008 to act in the best interests of the company, this is not always guaranteed.[34]

In light thereof, it is necessary to identify methods through which employees' interests will align to the interests of shareholders. Research has shown remuneration to be key in this attempt at alignment. For example, Oyer and Schaefer note that: "linking an employee's wealth to the value of the firm might overcome agency problems and motivate the employee to take actions that are in the firm's interest."[35]

One approach to achieve this alignment, is the use of short-term incentive schemes in terms of which employees receive a cash bonus if certain performance criteria are met. Although successful to some degree, there is a risk of employees becoming too focused on short-term profitability of the company and taking unnecessary risks as opposed to taking a long-term view.[36]

As such, share incentive schemes have become a popular mechanism through which to align the employees of a company with the long-term interests of both the company and its shareholders. Equity-based compensation in particular, whether settled in equity or in cash, is a useful tool through which the employee is motivated to drive the long-term growth and success of the company, as an increase in share price would result in the employee receiving a larger gain upon settlement. An advantage of this approach is that the employee is simultaneously provided with remuneration and ownership in the company, enabling that employee to share in the growth of that company.

2.2.2 Attraction, retention and reward of employees

Employee share incentive schemes have become a common tool in aiding the company's ability to both attract and retain employees.[37] The attraction and retention of employees

[34] Rutger Muurling and Thorsten Lehnert, "Option-based compensation: a survey." *The International Journal of Accounting*. 39 (2004): 365 – 401. See also the King IV Report on Corporate Governance, 26, https://www.adamsadams.com/wp-content/uploads/2016/11/King-IV-Report.pdf .
[35] Oyer and Schafer, 100.
[36] Muurling & Lehnert, 375.
[37] Nyelisani, 20; Jonas, 14.

are of significant importance in the current climate where the levels of employee mobility are high.[38]

Remuneration of which the payment is deferred until a future date, makes it costly for employees to leave the employ of their companies.[39] Employee share incentive schemes are typically subject to a vesting period and contain provisos which govern situations where the participant leaves the employ of the company prior to the vesting of the plan. Most often, unless otherwise indicated, employees will forfeit their rights to the value of their awards received under the scheme.[40]

2.3 Key variable features of employee share incentive schemes

Although employee share incentive schemes have evolved over time due to changes in legislation which has impacted the taxation of such schemes, certain key variable features remain of importance across all employee share incentive schemes) and are discussed below.[41]

2.3.1 Eligible employees

The eligibility of employees to participate in these schemes, also remain the prerogative of the employer company.[42] Initially, participation in employee share incentive schemes were largely limited to a company's executive directors and other executives.[43] As the requirements of companies changed over the years, so employee share incentive schemes evolved and participation was extended to lower levels of employees. The Broad-Based Black Economic Empowerment Act 53 of 2003 introduced Broad Based Black Economic Empowerment ("BBBEE") in South Africa. As a result, various companies

[38] Derek C Jones, Panu Kalmi & Mikko Mäkinen, "The productivity effect of stock option schemes: evidence from Finnish panel data," *Journal of Productivity Analysis* 33 (2010): 68.
[39] Oyer & Schaefer, 100.
[40] Employee share incentive scheme rules typically contain provisions setting out how an employee's awards will be treated upon termination of employment. Although most sets of scheme rules do provide for the eventuality where an employee is labelled as a "good leaver" and the termination of employment was not due to fault, it is the fault termination provisions (or "bad leaver") provisions which aid the retention of employees.
[41] Jonas, 33.
[42] Ibid.
[43] Jones et al, 70.

implemented share incentive schemes in such a manner as to increase and improve their BBBEE compliance ratings.[44]

2.3.2 SITs

Employee share incentive schemes often make use of a SIT[45] as a mechanism for the implementation of the scheme.[46] A SIT is an *inter vivos* trust and was originally used in the administration of share incentive schemes as a way to circumvent certain provisions of the Companies Act 61 of 1973 (which has since been repealed), which regulated the prohibition of financial assistance to executives, in a legal manner.[47] This prohibition has since been lifted in terms of the Companies Act 71 of 2008.[48]

The SIT is managed and administrated by its trustees. The SIT trust deed governs the following:[49]

1. Share option schemes: the awarding of share options to the selected participants;
2. Share purchase schemes: initiating the offers to purchase shares;
3. Allocating voting rights and dividend rights to the participants which are linked to their respective shares or units;
4. Administrating the loans granted to employees for purposes of purchasing shares in the SIT; and
5. Administrating the processes upon the termination of the employment of the participant.

The purpose of a SIT is primarily as a conduit between the participants and the employer companies and to hold company shares for the benefit of the participants.[50] The SIT itself

[44] Makgola Makololo, "The impact of Broad Based Black Economic Empowerment employee share schemes," MBA thesis, University of Pretoria, 2012, 3-4; Jonas, 33.
[45] Unless otherwise indicated, all references to "trust" in this dissertation refers to a SIT.
[46] Isaacman, 11.
[47] Bezuidenhout, 95-95; Jonas, 33.
[48] Jonas, 33 – 36 discusses the relevant provisions of the Companies Act in more detail. This section above is aimed at providing an overview as to the rationale behind the introduction of SITs, as well as to provide an overview of the typical functioning of a SIT so the tax consequences thereof may be understood more clearly.
[49] Butler, 12; Jonas, 35.
[50] Isaacman, 12; Jonas, 35.

is not aimed at producing income.[51] A SIT typically options the company shares for the benefit of participants in one of two manners: either the SIT purchases shares on the open market, or the company issues shares directly to the SIT.[52]

The employee share incentive scheme allows for the granting of a loan to the participant as a means of financing the purchase of the incentive (whether shares, options or units). The loan will typically be secured, with the acquired incentive acting as the required collateral for the repayment of the loan. The dividends to which the participant may become entitled over the repayment period of the loan, will be applied by the SIT and set off against the interest accrued on the loan and thereafter on the capital amount.[53]

2.3.3 Vesting

In the event where an employee share incentive 'vests'[54], the participant obtains a non-forfeitable right over the incentive. This means that the incentive is no longer subject to any suspensive or resolutive conditions and that the participant will be able to freely dispose of his or her incentive as he or she sees fit. In the instance of restricted equity instruments (as defined in the ITA, vesting will occur on the date on which all the restrictions imposed upon the employee share incentive falls away and the participant is free to sell his or her shares.[55]

Employee share incentives are often subject to certain vesting conditions, or, in other words, conditions which places restrictions on the incentive until such time as the conditions are either met, or the incentives are forfeited.[56] Vesting conditions are typically suited to the needs of the company and the nature of the award, i.e. where the award of employee share incentives are made purely for purposes of the retention of an employee, the award is likely to only be subject to the employee's continued employment with the company ("service condition").[57] Incentives are further also typically subject to

[51] Ibid.
[52] Isaacman, 12; Butler, 12; Jonas, 35.
[53] Ibid.
[54] In determining the tax consequences of employee share incentive schemes, specifically the point at which the benefits received in terms of these schemes are taxed, it is important to understand the concept of vesting.
[55] Isaacman, 13.
[56] Ibid.
[57] Ibid; Bezuidenhout, 11-12.

performance conditions, whether of a financial or non-financial nature which ensures that employees are motivated to drive the performance of their respective companies.[58]

Awards of employee share incentives are typically subject to a mixture of the vesting conditions as set out above, which conditions are typically in place for a pre-determined period of time.

2.3.4 Settlement mechanisms

Incentive awards across the different schemes are most commonly settled either in equity (where a participant receives actual company shares upon the vesting of the award), or in cash, which cash amount is derived from the share price of a company share.[59]

Cash-settled schemes have the advantage of not causing dilution of the shareholding of a company's existing shareholders. On the other hand, businesses that typically do not have a high free cash flow, would have difficulty having to settle awards in cash.

Equity-settled schemes have the benefit of providing participants with a share in the ownership in their respective companies, which in turn should increase the motivation of the employees to drive the growth and success of their respective companies.[60] This is of particular relevance in broad-based employee share schemes where the purpose of the scheme is to provide previously disadvantages employees with the opportunity to hold shares in their employer company.

2.4 Common types of schemes

Employee share incentive schemes have evolved over the years, both as a result of the needs of the various companies, as well as to ensure that the structures of these schemes remained as tax efficient as possible in light of the changes to income tax legislation.

Although a variety of employee share incentive schemes are found in the market today, studies[61] have indicated that the most prevalent schemes which make use of a SIT, are: share option schemes, share purchase schemes, phantom share schemes, restricted

[58] Jonas, 37; Bezuidenhout, 11-12. See also the King IV Code on Corporate Governance for South Africa: A guide to the application of King IV: Governance of remuneration, 5.
[59] Jonas, 36.
[60] Global Equity Insights, 2017.
[61] Global Equity Insights, 2017, 3 and 9; Jonas, 12; Bezuidenhout, 3.

share schemes and BBBEE schemes. This section will focus on the aforementioned schemes.

2.4.1 Share purchase scheme

In order to understand the evolution of the various share incentive schemes over time, one must commence the analysis of a common share incentive scheme utilising a SIT by exploring a traditional share purchase scheme.

A share purchase scheme consist of an employee SIT, set up by the employer company for the benefits of its employees. The SIT will acquire the required number of shares allotted to participants by either subscribing to shares or by purchasing shares on the market.[62] The SIT will finance this acquisition by way of a loan granted to the trust by the employer company.[63]

Participants are offered the opportunity to purchase a predetermined number of company shares from the SIT, usually at a price equal to the market value of the shares on the date on which the offer is made to the employees.[64] The participants typically finance this purchase by way of a loan account in terms of which the employees where indebted to the SIT, with repayment of the loan occurring over tranches. The shares purchased by the participant act as security for the loan.[65]

The ownership of the purchased shares, as well as other inherent shareholder rights such as dividends and voting rights that attach to the shares, are transferred to the participant upon the acquisition of the shares. Typically, the dividends payable with regards to the shares and which accrue to the participant, are used by the SIT to set off the loan until the loan is extinguished.[66]

[62] Isaacman, 16; Jonas, 4; Butler, 13.
[63] Ibid.
[64] Ibid.
[65] Ibid.
[66] Jonas, 40.

2.4.2 Option-type schemes

2.4.2.1 Overview

Option-type schemes generally fall into two categories: a traditional share option scheme, or a share appreciation rights scheme. Both share option schemes and share appreciation rights schemes generally require the participant to remain in the employ of the company throughout the vesting period of the award.[67] Where the participant's employment terminates before vesting, awards may be forfeited in their entirety, depending on the reasons for the termination of employment.[68]

Option-type schemes have the advantage of driving share price growth in the company as participants to these schemes will only benefit where the market value of an option-type incentive on the exercise date exceeds the market value on the grant date, as the participant will share in the growth. A disadvantage is that, where the share price at exercise is lower than the share price at grant, the options or share appreciation rights will be "out-of-the-money" and will hold no value to the participants, thereby rendering the retention and reward element of these schemes ineffective.

Option-type schemes are particularly popular with companies that are in a growth phase, or companies that have a trend of constant share price growth, or companies that wish to drive the growth in the share price.

2.4.2.2 Share Option Schemes

Employees in the company are offered the right to purchase a fixed number of company shares at a fixed price by either the company or by a SIT. The price will typically be the price of a share at the award date. The options granted to the participant are typically exercisable over a pre-determined period of time, often ranging between three years and seven years. Upon the exercise of the option, the participant will pay the full amount of the options, determined at the price as at award date.[69] Once the participant has paid the full price, the full ownership of the shares will be transferred to him or her.[70] There is no

[67] Isaacman, 16.
[68] Ibid.
[69] Jonas, 39-40.
[70] Isaacman, 16.

obligation on the participant to exercise his or her options. The participant will receive no dividends or voting rights until such time as the option is exercised, the full amount paid and the ownership of the shares is transferred to the participant.

The exercise of the share options is typically restricted until such time as the vesting period has lapsed, which could occur either in tranches, or at once. Subsequent to the lapse of the vesting period, the participant will be eligible exercise his or her option over a period of time (the exercise period). The participants are typically free to exercise their options at any time during the exercise period, thereby taking advantage of the highest possible share price.[71]

2.4.2.3 Share appreciation rights

Similar to share options, share appreciations rights are awarded to the participant at the market value at the grant date. Share appreciation rights differ from share options since participants do not have to pay to receive shares in the company. The participant will be eligible to receive the net gains of the growth in the market value upon the exercise date.

2.4.3 Phantom share plan

A phantom share scheme, as the name indicates, differs from the share purchase scheme and option-type schemes set out above in that the participants to the scheme do not receive a right to acquire actual company shares. Instead, participants to a phantom share scheme are awarded a number of units or “phantom shares” by either the company or through the use of a SIT. The value of these phantom shares will be derived from the value of the underlying share capital of the company.[72]

The phantom shares may be subject to performance conditions as well as a service conditions. Upon the vesting of the phantom shares, the participant will receive an amount equal to the market value of the shares at the vesting date. The participant therefore has the benefit of sharing in the growth in the company and the motivation to grow the share price of the company, as an increased share price ultimately benefits the participant upon the vesting date.

[71] Jonas, 40.
[72] Jonas, 5.

Participants in a phantom share scheme may also receive dividend equivalents for the duration of the vesting period which in turn further aligns the participant's interests to that of the shareholders of the company.[73] Dividend equivalents are amounts distributed to the participants equal in value to the dividends which they would have received had they held actual equity shares in the company from which these dividend equivalents were derived.[74]

2.4.4 BBBEE employee share scheme

In order to understand and fully appreciate the impact of the amendments to the anti-avoidance provisions in the ITA upon a BBBEE employee share ownership scheme, one must briefly explore the rationale and purpose behind the implementation of these schemes.[75]

The concept of BBBEE was introduced as a mechanism through which people and communities previously oppressed under the apartheid regime would be transformed and uplifted. In 2003, as part of the government's legislative framework for the transformation of the South African economy, the BBBEE Strategy was introduced as a prelude to the Broad-Based Black Economic Empowerment Act 53 of 2003.

Following the implementation of the BBBEE Act, the government introduced the BBBEE Codes of Good Practice in February of 2007 as a framework through which BBBEE is implemented. A company's BBBEE status is assessed using a scorecard, in terms of which the company is awarded points compliance with different aspects of BBBEE. A high BBBEE score is beneficial to a company, in particular in the context of preferential procurement.[76]

The BBBEE scorecard contains various elements, one of which being ownership (DTI, 2007). As such, since the implementation of BBBEE, companies have aimed to address

[73] Isaacman, 18.
[74] These dividend equivalents to not arise from a participant's inherent right to dividends in respect of an actual company share, but rather on a contractual basis and/or on the discretion of the company.
[75] In order for BBBEE schemes to contribute to the available BBBEE ownership points, the schemes must meet a list of predetermined criteria as contained in the Codes of Good Practice. The aforementioned criteria does not form part of the scope of this study and, as such, is not addressed in detail, safe in instances as pertains to answering the research question(s).
[76] Richard Ramplin, "Viability of a BBBEE Employee Share Trusts: A Case Study of an Engineering Consulting Firm," MPhil thesis, University of Cape Town, 2016, 3.

this element and better their BBBEE ratings through the implementation of employee share incentive schemes. These schemes are predominantly run through the use of a SIT, in terms of which shares are issued to employees identified to be of previously disadvantaged backgrounds.[77] The employee shares are "locked in" for a predetermined period of time, meaning that the employees cannot freely dispose of their shares.[78]

The SIT will acquire shares in the company, either by way of a fresh issue of shares to the SIT, or by way of purchasing the shares. In the instances where the SIT is required to purchase the share, one typically finds that the company grants a loan to the SIT through which the purchase of shares is financed, where after the SIT is required to repay the loan amount before any dividends can flow through to the participants.[79]

Participants, upon accepting the units, are immediately entitled to:

1. their share of the dividends received by the SIT;
2. their proportional right to the net capital proceeds upon the realisation of the shares; and
3. a right to the underlying shares in the SIT upon the expiry of the lock-in period.

2.5 Conclusion

The aim of this chapter was to provide the necessary context for the discussions in chapters 3 and 4 with regards to the anti-avoidance provisions in section 8C, section 10(1)(k)(i) and the Eighth Schedule which impact on employee share incentive schemes operating through SITs by considering the most prevalent employee share incentive schemes in South Africa which utilise SITs.

This chapter explored the rationale behind companies adopting share incentive schemes and the key variable features of employee share incentive schemes. It also set out the salient features of the most prevalent employee share incentive schemes which typically make use of a SIT.

[77] Makololo, 3.
[78] Ibid.
[79] Ramplin, 4-5.

As is clear from the discussion above, employee share incentive schemes are common in South Africa and have evolved over time due in part to the changes in income tax legislation impacting adversely upon these schemes and the benefits which participants derive therefrom. The most prevalent employee share incentive schemes which are run through trusts are share purchase schemes, share option schemes, deferred delivery schemes and phantom share schemes.

In order to understand:

1. how the various changes in South African income tax legislation over the past decade affected how participants to the above employee share incentive schemes operating through SITs are taxed in terms of section 8C, section 10(1)(k)(i) and the Eighth Schedule; and
2. whether any anomalies were created by and/or addressed by the amendments to the anti-avoidance provisions;

one must proceed to examine the development of these anti-avoidance provisions impacting on the above schemes operating through SITs over the last decade. This is done in Chapter 3 below.

Chapter 3: Anti-avoidance provisions impacting on employee share incentive schemes run through trusts

3.1 Introduction

In an attempt to prevent employee share incentive schemes, particularly those operating through share incentive trusts ("SITs") being used as mechanisms through which employees could avoid paying income tax on equity-based remuneration, various anti-avoidance provisions were introduced in section 8C, section 10(1)(k)(i) and the Eighth Schedule of the ITA over the past decade.

This chapter aims to explore the development of these anti-avoidance provisions impacting on employee share incentive schemes operating through SITs over the last decade, with a focus on identifying anomalies created by and/or addressed by the amendments to these provisions.

In order to achieve this objective, this chapter sets out the history and original purpose behind the implementation of the key anti-avoidance provisions contained in section 8C, section 10(1)(k)(i) and the Eighth Schedule the ITA which impact on the tax consequences of employee share incentive schemes operating through trusts.

The significant amendments to these provisions over the past decade is further explored. The most recent amendments to and the current wording of the anti-avoidance provisions in section 8C and section 10(1)(k)(i) is also explored. This chapter also sets out the implication of the wording of the current anti-avoidance provisions in section 8C and section 10(1)(k)(i) as they stand on the employee share incentive schemes as set out in Chapter 2. Comments on the effectiveness of these anti-avoidance provisions in achieving the purpose for which they were implemented are included.

This chapter further identifies anomalies created by the amendments to the anti-avoidance provisions in order to provide the context required to understand the discussion in Chapter 4 below in respect of the perceived anomalies which still persist in relation to the CGT implications of employee share incentive schemes operating through SITs.

3.2 The tax implications of share incentive schemes –section 8C

3.2.1 Background to the introduction of section 8C

Equity-based incentive schemes have developed over the years so as to provide a mechanism through which employees are awarded compensation in the form of equity in their employer companies. Prior to 1969, these schemes were an effective way of providing employees with remuneration in the form of equity which resulted in the employees having to pay minimal tax costs. The type of schemes employed varied, but typical schemes included restricted shares schemes, deferred delivery schemes, share option schemes and convertible debentures.[80]

In 1969, section 8A of the ITA was introduced[81] in an attempt to address and regulate the tax consequences of equity-based incentive schemes so as to try and ensure that employees do not avoid paying the income tax on equity-based remuneration. In terms of this provision, gains resulting from the exercise, cession or release of a right to acquire a marketable security[82] were to be included in the income of the taxpayer if the taxpayer obtained this right as a result of the services he or she rendered to the company.

Although section 8A made strides in reducing the tax benefits participants to share incentive schemes were enjoying prior its introduction, certain loopholes remained. Over time, employee share incentive schemes continued to evolve in an effort to remain as tax efficient as possible and to ensure that employees paid as little income tax as possible.[83]

In light of the evolution of employee share incentive schemes following the introduction of section 8A, it was determined in 2004 that section 8A had become ineffective in achieving the aim for which it was originally enacted. Specifically, the Explanatory

[80] National Treasury, "Explanatory Memorandum on the Revenue laws Amendment Bill, 2004," 10, accessed on 4 April 2018, http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2004-02%20-%20%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202004.pdf.
[81] Section 8A of the ITA was inserted by section 11 of the Revenue Laws Amendment Act 89 of 1969.
[82] A marketable security was defined in section 8A(10) as "any security, stock, debenture, share, option or other interest capable of being sold in a share-market or exchange or otherwise."
[83] Jonas, 21.

Memorandum issued by the South African Revenue Service (hereafter referred to as "SARS") in 2004, stated the following: [84]

1. Firstly, section 8A was deemed to have failed in staying abreast and properly addressing the variety of equity-based incentive schemes that had developed since its inception.
2. Secondly, section 8A "fail[ed] to fully capture all the appreciation associated with the marketable security as ordinary income."
3. Finally, tax advantages associated with these equity-based incentive schemes were contrary to the concept of "vertical equity".[85] The Explanatory Memorandum emphasised that top management should not receive the fringe benefit of being taxed at lower rates as a result of receiving a portion of their remuneration in equity, when lower level employees who were purely salary-based were subject to full income tax on their salaries.[86]

In light of this, the Revenue Laws Amendment Act 32 of 2004 resulted in two significant amendments to the ITA:

1. Section 8A was amended by section 7 of the Revenue Laws Amendment Act 32 of 2004 to only apply to rights obtained by the taxpayer before 26 October 2004 in respect of services rendered or to be rendered.
2. The Revenue Laws Amendment Act, 32 of 2004 further amended the ITA in section 8(1) by the insertion of section 8C.[87] Section 8C came into effect on 26 October 2004 and is applicable "in respect of any equity instrument acquired on or after that date, otherwise than by way of the exercise of any right granted before that date and in respect of which section 8A applies".[88]

[84] National Treasury, 2004, 10.
[85] This concept requires employees to be taxed at their top marginal rate on their earnings, as opposed to the maximum capital gains rate (National Treasury, 2010, 17).
[86] National Treasury, 2004, 10.
[87] For detailed discussions with regards to the introduction of section 8C, refer to Jonas and Bezuidenhout respectively.
[88] Section 8(1) of the Revenue Laws Amendment Act, 32 of 2004.

One of the main aims of this section is to ensure that the awards of restricted equity instruments received by employees are taxed as growth-related salaries at the employee's marginal rate and to prevent the gain received by the employee as being artificially classified as a capital gain.[89] Section 8C places an obligation on a taxpayer to include in his or her income for a year of assessment any gain (or loss) determined in terms of section 8C(2) and which gain arose from the vesting[90] of a restricted equity instrument during the year of assessment. The aforementioned is subject to the taxpayer having acquired the restricted equity instrument by virtue of his or her employment.

A restricted equity instrument, as emphasised by the Explanatory Memorandum, "represents an interest in the equity shares underlying the scheme that is held either directly or through a derivative mechanism. The retention or acquisition, by a scheme participant, of the benefits flowing from the scheme, e.g. dividends, is subject to suspensive or resolutive terms or conditions."[91] As such, where an employee receives a gain upon the vesting of an incentive, whether in the form of equity or in cash, that gain must be included in the employee's income for the year of assessment.

3.2.2 Significant amendments to anti-avoidance provisions impacting on employee SITs over the past decade

Section 8C has evolved significantly since its enactment in 2004 and remains the primary provision in the ITA addressing the taxation of restricted equity instruments and ensuring that gains from such instruments are included in the ordinary income of employees.[92] The

[89] National Treasury, "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010," 17, accessed 5 June 2018, http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2010-01%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202010.pdf.
[90] Section 8C differs from various other anti-avoidance provisions, in that it aims to defer the point of taxation, rather than accelerate it. The point of taxation in terms of section 8C is intended to be at the point where an employee's award vests and the employee is able to freely dispose of the equity instrument as all the restrictions upon the equity instrument has fallen away.
[91] National Treasury, "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2016," 14, accessed 30 April 2018, *http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2016-02%20-%20EM%20on%20the%20Taxation%20Laws%20Amendment%20Bill%2017B%20of%202016%2015%20December%202016.pdf*.
[92] National Treasury, "Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008," 22 accessed 28 April 2018, h*ttp://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2008-01%20-%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202008.pdf*.

significant amendments set out below are focused on those amendments over the past decade which relate specifically to anti-avoidance provisions impacting on SITs.

In 2008, anti-avoidance measures were introduced to regulate the tax consequences of employee share incentive schemes run through SITs. The rationale provided for this amendment to the ITA, was that employee share incentive schemes had developed in such a way so as to avoid the application of section 8C on artificial technical grounds.[93] Specifically, a number of schemes had evolved so as to utilise SITs as vehicles in which shares were held and in which a participant did not obtain a right to the actual underlying shares, but rather a right to the value of the shares held in the SIT. This resulted in participants having the advantage of obtaining the value of what would otherwise have constituted a certain number of shares, without the burden of having to include the value in their gross income (since section 8C did not find application due to there being no award of equity shares).

Section 11 of the Revenue Laws Amendment Act 60 of 2008, amended section 8C by inserting section 8C(1A) and by amending subsection (7). The latter in effect widened the ambit of section 8C as it amended the definition of "equity instrument" through section 8C(7)(c) through the inclusion of the following:

> *"any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member's interest."*

The above amendment resulted in section 8C finding application where the participant received an interest in a trust, even in instances where the right pertains solely to the value of the underlying shares held in the trust and not to the shares themselves.

The Explanatory Memorandum 2016 highlights the fact that section 8C is based on "the implicit assumption that the full value of the equity shares underlying a restricted equity instrument will vest in the employee when the restrictions fall away."[94] This is, however, not always the case. Various incentive scheme structures were designed in such a way so as to either liquidate the value of the underlying scheme shares, either in part or wholly, by disposing of or redeeming the underlying shares before the shares became

[93] Ibid.
[94] National Treasury, 2016, 14-15.

unrestricted and distributing the value to the participant in the form of a dividend. Aside from the fact that these schemes allowed a participant to benefit by paying less tax on the distributions received, it also lessened the value of the underlying shares which in turn lead to a lower tax rate.[95]

As a result, further amendments were made to section 8C[96] in 2016 to further prevent the characterisation of amounts received by virtue of employment as capital gains or as dividends.[97] Section 13(1) of the Taxation Laws Amendment Act 15 of 2016 amended section 8C(1A) to extend its application to include amounts received by or accrued to a taxpayer during a year of assessment in respect of a restricted equity instrument, provided that the amount does not constitute:[98]

1. A dividend in respect of the restricted equity instrument;
2. A return of capital by way of distribution of a restricted equity instrument; or
3. An amount that must be taken into account in respect of a restricted equity instrument for purposes of section 8C.

The wording of this section makes it clear that, where a SIT disposes of a restricted equity instrument and vests the profits in the participants, the amount received by the participants must be included in their taxable income for the year of assessment. In fact, the section is worded in such a way as to include all amounts received by the participant in respect of the restricted equity shares in the participant's income, save for three exceptions. Amongst others, dividends in respect of the restricted equity instrument are specifically excluded from the participant's income and will be subject to dividends tax.

The above amendment to the ITA gave rise to an unintended further anomaly with regards to the interaction between section 8C(1A) and paragraph 80(2A) of the Eighth Schedule. The anomaly and the relevant steps taken to attempt and address the anomaly is discussed below.

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[95] Ibid.
[96] The 2016 legislative cycle also brought related amendments to section 10(1)(k)(i) of the Act. Refer to the sections below.
[97] National Treasury, 2016, 14-16.
[98] Ibid, 16.

The 2017 legislative cycle did not bring about any further significant changes to provisions in section 8C.

3.2.3 Conclusion: Effectiveness of the anti-avoidance provision

Section 8C manages to successfully encapsulate any and all amounts received by or accrued to an employee in respect of a restricted equity instrument which do not fall within any of the exceptions. In respect of employee SITs, this section appears to successfully prevent amounts being characterised as capital gains or dividends by specifically including amounts received by virtue of the employee's employment and participation in these schemes as income.

It is clear from section 8C, as it currently reads, that an amount received by or accrued to an employee by virtue of his employment in respect of a restricted equity instrument, will be included in the employee's taxable income for the year of assessment, irrespective of whether the amount is derived from a gain arising from the vesting of the equity instrument in the employee, or the profits of the sale of the equity instruments which are vested in the employee. This means that, irrespective of whether an employee participates in an equity-settled employee share incentive scheme or a phantom cash settled incentive scheme, the gains received by the employee by virtue of his employment will be taxed as income in the hands of the employee.

Following the above amendment and the current wording of section 8C(1A), one must explore the wording of the anti-avoidance provision relating to dividends which should be read in tandem to the above section 8C(1A), as it is clear from the above that only dividends, as defined by the ITA, will be excluded from the income of a participant for purposes of section 8C(1A).

3.3 The exemptions to income tax in respect of dividends – section 10(1)(k)(i)

3.3.1 Background

Dividends are included in a taxpayer's gross income by way of paragraph (k) of the gross income definition in section 1(1) of the ITA. Dividends may be exempt from normal income in terms of section 10(1)(k)(i). The proviso to section 10(1)(k)(i) sets out various

exceptions to the exemption and has been the subject of amendment in numerous legislative cycles.

Prior to 2011, participants to employee share incentive schemes had the advantage of receiving exempt dividends by virtue of their participation in a scheme. In light of this tax benefit, various share incentive schemes were set up in a manner as to allow the employees participating in the scheme to receive dividends exempt from income tax, without the participant having any other participation rights.[99]

Phantom share incentive schemes, for example, were put in place in terms of which a participant was granted a number of phantom shares or a number of units which were linked to the value of the company's equity share capital. Employees in these schemes were then able to receive dividend equivalents, being amounts distributed to the participants equal in value to the dividends which they would have received had they held actual equity shares in the company from which these dividend equivalents were derived. The participants had the benefit of receiving these dividend equivalents exempt from income tax, whilst not holding any actual equity shares. Such schemes were often structured in such a manner so as to convert a participant's salary into dividends which in turn significantly reduced a participant's tax liability, as these dividends were exempt from income tax.[100]

In order to address the avoidance of income tax resulting from such schemes, section 10(1)(k)(i) was amended and paragraph (dd) was introduced in 2010.

3.3.2 Significant amendments to anti-avoidance provisions impacting on employee SITs over the past decade

3.3.2.1 Paragraph (dd)

Section 18(1)(m) of the Taxation Laws Amendment Act 7 of 2010 introduced paragraph (dd) in an attempt to aid the prevention of taxpayers masking their salaries through the use of employee share incentive schemes that would result in the taxpayer being taxed at a lower rate (in the instance of capital gains), or not at all. Paragraph (dd) excluded

[99] Participation rights are rights which are linked to the share, such as voting rights and the right to receive dividends. See Jonas, 52.
[100] Jonas, 52-53.

from the dividend exemption in section 10(1)(k)(i) dividends in respect of section 8C equity instruments, unless the restricted equity instrument constituted an "equity share" or the dividend constituted an equity instrument for purposes of section 8C.

In addition to the introduction of paragraph (dd), the definition of "equity share capital" was substituted by section 6(1)(g) of the Taxation Laws Amendment Act 7 of 2010 for a definition of "equity share" which meant, in relation to any company, "any share or similar interest in that company, excluding any share or similar interest that does not carry any right to participate beyond a specified amount in distribution". This meant that, where a participant in an employee share incentive scheme operating through a SIT only had a right to receive distributions in respect of the scheme, but held no other participation rights, the participant's interest in the SIT did not extend beyond the right to "a specified amount in distribution."

The purpose of paragraph (dd) and the substitution of the definition of "equity share" was specifically to prevent income being disguised as dividends which are taxed at a lower rate. This was aimed at addressing preference share schemes, which were set up in such a way as to introduce a special class of shares which gives the employee the right to receive larger than normal dividends.[101] As a result of these 2010 amendments, preference shares no longer qualify as "equity shares" which in turn results in dividends received in respect of preference shares no longer being exempt from income tax.

By excluding shares or similar interests that do not carry rights other than the right to receive specified amounts in distributions from the definition of "equity share", this definition effectively excluded any distributions received by participants to employee share incentive schemes operating through SITs that were not received in respect of actual equity shares as defined from being exempt from income tax.

The introduction of paragraph (dd) and the substitution of the definition of "equity share" had the unintended consequence of negatively impacting upon employee share incentive schemes operating through SITs where participants held shares through the SIT. The

[101] National Treasury, "Explanatory Memorandum on the Taxation Laws Amendment Act, 2011," 15, accessed 1 May 2018, *http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2011-02%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202011.pdf*.

2010 amendments to paragraph (dd) and the definition of "equity share" inadvertently resulted in dividends received by participants on shares held for their benefit in a SIT being taxed as income. [102]

In an attempt to narrow the extensive application of paragraph (dd), section 28(1)(n) of the Taxation Laws Amendment Act 24 of 2011 further amended paragraph (dd) so as to include a carve-out provision in terms of which dividends paid to participants in respect of section 8C restricted equity instruments remained exempt from tax, provided that the restricted equity instrument constituted an interest in an employee SIT holding only equity shares.[103]

> *"(dd) to any dividend in respect of a restricted equity instrument as defined in section 8C to the extent that the restricted equity instrument was acquired in the circumstances contemplated in section 8C, unless-*
>
> *(A) The restricted equity instrument constitutes an equity share, other than an equity share that would have constituted a hybrid equity instrument as defined in section 8E (1) but for the three-year period contemplated in that definition;"*

The Explanatory Memorandum to the Taxation Laws Amendment Act 24 of 2011 emphasised that the intention behind paragraph (dd) was never to tax the dividends receivable by participants on equity shares held by an employee SIT for their benefit.[104]

Paragraph (dd) is of particular importance in respect to employee share incentive schemes operating through SITs as it addresses dividends in respect of restricted equity instruments.[105] Whereas section 8C governs the tax consequences arising on the vesting of restricted equity instruments which were acquired by virtue of the participant's employment, the dividends which the employee receives by virtue of those restricted equity instruments are taxed as ordinary income in the hands of the participant unless the dividend falls within one of the three exceptions cited above.[106]

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[102] Ibid.
[103] Jonas, 54.
[104] National Treasury, 2011, 14 -15.
[105] Madeleine Stiglingh et al., *Silke on South African Income Tax 2017* (LexisNexis, 2018), 81.
[106] Ibid.

Therefore, where participants receive dividends on restricted equity instruments and the restricted equity instruments qualify as "equity shares" for purposes of the ITA; or where the restricted equity instrument constitute an interest in a SIT where the SIT holds only equity shares, the dividends will be exempt from income tax. Where a participant in a scheme is eligible to receive dividend equivalents, those dividend equivalents will not be classified as dividends in respect of qualifying equity shares and will as such be taxed as ordinary income in the hands of the participant.

3.3.2.2 Paragraph (ii)

Following the amendments to paragraph (dd), section 23(1)(p) of the Taxation Laws Amendment Act 31 of 2013 introduced paragraph (ii) to section 10(1)(k)(i). The Explanatory Memorandum stated that the anti-avoidance rule in paragraph (dd) was deemed to be too narrow as it only targeted dividends derived from non-equity shares. This meant that employee share incentive schemes could hold equity shares for the primary purpose of generating dividends for the participants. These dividends were essentially disguised salaries and the participants never obtained ownership of the shares.[107]

The Explanatory Memorandum further emphasised the following important policy consideration:

> *"According to policy, if an employer pays an employee for services rendered, the amount should be included in gross income and taxed at marginal rates irrespective of how the employer funded the payment. Furthermore, the same tax consequences should flow irrespective of whether the payment was made directly or indirectly by the employer to the employee (e.g. facilitated through an employee share trust)."*[108]

Paragraph (ii) was therefore introduced to target dividends paid to participants in respect of their employment or services rendered and to ensure that these amounts were appropriately taxed as income and not as dividends. Paragraph (ii) was structured in such

[107] National Treasury, "Explanatory Memorandum on the Taxation Laws Amendment Act, 2013," 25, accessed on 4 May 2018, *http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2013-02%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202013.pdf*.
[108] National Treasury, 2013, 25.

a way as to not negatively affect *bona fide* employee share incentive schemes as is clear from the wording below:

> *"(ii) to any dividend received by or accrued to a person in respect of services rendered or to be rendered or in respect of or by virtue of employment or the holding of any office, other than a dividend received or accrued in respect of a restricted equity instrument as defined in section 8C held by that person or in respect of a share held by that person."*

Paragraph (ii) has been the subject of much debate as it addresses the tax consequences of dividends paid in respect of services rendered.[109] In order to prevent income for services rendered as being disguised as a dividend, such dividends received as a result of services rendered will not be exempt from normal tax, unless the dividend is received in respect of a restricted equity instrument as defined in section 8C, in which instance the tax consequences of that dividend will be governed under paragraph (dd) set out above.[110]

The interaction between paragraphs (dd) and (ii) is intended to curb the avoidance of tax through the characterisation of income as dividends, whilst at the same time offering specific exclusions so as to not penalise employee beneficiaries to employee share incentive schemes on any dividends they may receive.

3.3.2.3 Paragraph (jj)

The ITA was further amended by section 23(1)(d) of the Taxation Laws Amendment Act 15 of 2016 so as to introduce paragraph (jj) to section 10(1)(k)(i) in order to exclude certain dividends from the tax exemption on certain dividends. Paragraph (jj) was specifically aimed at combatting the various preference share structures that arose in an attempt to mitigate the tax consequences of section 8C.[111]

In terms of these schemes, participants were able to receive larger than normal income in the form of dividends which were then taxed as dividends, rather than at the employee's

[109] See the Explanatory Memorandums issued during 2015 and 2016 respectively for a discussion on the problems surrounding the dividends exemption.
[110] Stiglingh et al, 80.
[111] National Treasury, 2016, 15-16.

marginal tax rate. Paragraph (jj) applies notwithstanding the provisions of paragraphs (dd) and (ii) and excludes from the exemption from income tax, dividends in respect of restricted equity instruments if the dividend is derived directly or indirectly from (or constitutes):

1. An amount transferred or applied by accompany as consideration for the acquisition or redemption of any share in the company;
2. An amount received or accrued in anticipation or in the course of the winding up, liquidation, deregistration or final termination of a company; or
3. An equity instrument that is not a restricted equity instrument as defined in section 8C, that will on vesting be subject to that section.

3.3.2.4 Paragraph (kk)

Paragraph (kk) was introduced into the ITA during the 2017 legislative cycle with the aim of further refining the existing anti-avoidance measures aimed at schemes where restricted shares held by participants are liquidated in return for an amount which constitutes a dividend.

These paragraphs are specific anti-avoidance measures aimed at structures where employee beneficiaries receive a dividend in respect of restricted equity instruments which the employee received by virtue of his employment and which dividend constitutes a distribution of the value of the underlying shares which were liquidated before the restrictions fell away. It is important to note that paragraphs (jj) and (kk) override the provisions of paragraphs (dd) and (ii). The dividend will not be exempt from normal tax in the following instances:

> *"to any dividend in respect of a restricted equity instrument as defined in section 8C that was acquired in the circumstances contemplated in section 8C (1) if that dividend is derived directly or indirectly from –*
>
> *(A) An amount transferred or applied by a company as consideration for the acquisition or redemption of any share in that company;*
>
> *(B) An amount received or accrued in anticipation or in the course of the winding up, liquidation, deregistration or final termination of a company."*

No further amendments were made to the other anti-avoidance paragraphs in section 10(1)(k)(i).

3.3.3 Conclusion: Effectiveness of the anti-avoidance provision

The anti-avoidance provisions impacting on employee share incentive schemes operating through SITs contained in section 10(1)(k)(i) appear to succeed in meeting their purpose and prevent the characterisation of employment income as exempt dividends when applied to the most common employee share incentive schemes in their standard form. Structures through which employees receive income disguised as larger-than-normal exempt dividends are no longer an effective way of characterising employment income as a dividend. The provisions ensure that dividends received by an participant by virtue of his employment will be excluded from the exemption from normal tax, unless the dividend is received or accrued in respect of a restricted equity instrument as defined in section 8C which is held by the employee (sub-paragraph (ii)).

In respect of employee share incentive schemes, the above provisions result in dividend equivalents being taxed as normal income in the hands of the participant as these do not qualify as dividends received in respect of equity shares. Full-share type schemes and/or share option schemes where shares are acquired upfront, but remain subject to disposal restrictions, would enable the employee, as a shareholder, to receive dividends over the restricted period which will be exempt as these dividends would have been received in respect of an equity share.

3.4 The taxation of capital gains – anti-avoidance provisions contained in the Eighth Schedule aimed at preventing income being characterised as a capital gain

3.4.1 Background

Capitals Gains Tax (hereafter referred to as “CGT”) was introduced into the ITA during the 2001 legislative cycle and its introduction impacted the manner in which employee share incentive schemes are taxed. The Explanatory Memorandum in setting out the

rationale for the (then) proposed amendments, noted the following as it pertains to trusts and the beneficiaries to trusts:[112]

> *"a capital gain arising from the disposal of a trust asset will be taxable either in the hands of the trust or, where an attribution rule applies, in the hands of a beneficiary or a person who made a donation, settlement or other disposition to the trust."*

The introduction of paragraph 80 of the Eighth Schedule in particular had a significant impact on employee SITs and the participants thereto. This provision was introduced to allow capital gains determined in respect of the disposals of trust assets to resident trust beneficiaries to be ignored in the hands of the trust, and to be treated as capital gains in the hands of the beneficiary. As such, the attribution of a capital gain to a beneficiary results in a lower effective tax rate in respect of capital gain, than a capital gain which is taxed in the hands of a trust, thereby benefiting the trust beneficiaries.[113]

3.4.2 Significant amendments to anti-avoidance provisions impacting on employee SITs over the past decade

Section 8C, as is clear from the discussion in 3.2 above, provides for the inclusion of the gains received from equity instruments in terms of participation in employee share incentive schemes in the participant's gross income in the year of assessment when the equity instrument vests in the participant.

In 2015, amendments were made to the ITA by the Taxation Laws Amendment Act 25 of 2015 for the purpose of addressing the anomaly which existed in the interaction between the taxation of employee share incentive schemes operating through SITs in terms of section 8C and the attribution provisions contained in the Eighth Schedule relating to the timing of the disposal and the subsequent attribution of capital gains to the participants.

[112] National Treasury, "Explanatory Memorandum on the Revenue Laws Amendment Bill, 2001*,"* 105 accessed 30 April 2018, http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2001-01%20-%20%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202001.pdf.
[113] Ibid, 106.

Paragraph 11(2)(j) was originally inserted into the Eighth Schedule to the ITA to ensure that qualifying section 8C restricted equity instruments do not trigger a disposal event for purposes of CGT before the restrictions falling away on the vesting of the instrument.

The Explanatory Memorandum to the Taxation Laws Amendment Bill 2015 stated that it has become evident that paragraph 11(2)(j) of the Eighth Schedule, as it then stood, was being misinterpreted to mean that the disposal of equity instruments by a trust to an participant was a non-event for CGT purposes.[114]

As such, the amendments sought to clarify that where an employee SIT disposes of equity instruments to a participant, the recognition of the capital gain in the SIT is deferred until the equity instruments vest for purposes of section 8C.[115]

The ITA was subsequently amended as follows:

1. Paragraph 11(2)(j) was deleted[116] so as to address the misinterpretation of there being no disposal event by a trust.[117]
2. Paragraph 13(1)(a)(iiB) was inserted[118] so as to ensure that there is a disposal event where a trust grants a restricted equity instrument to a qualifying participant. The CGT implications are deferred until such time as the restricted equity instrument vests for purposes of section 8C.[119]
3. Amendments were made to paragraph 80(1)[120] which aimed to clarify the following:[121]
    a) Any gains which resulted from the employee SIT disposing of shares to participants, remained taxable in the trust and were not attributed to the participants.

[114] National Treasury, 2015, 10.
[115] National Treasury, 2015, 10.
[116] Amended by section 105(1)(b) of the Taxation Laws Amendment Act 25 of 2015.
[117] National Treasury, 2015, 10.
[118] Inserted by section 107(1) of the Taxation Laws Amendment Act 25 of 2015.
[119] National Treasury, 2015, 10-11.
[120] Amended by section 123(1)(a) of the Taxation Laws Amendment Act 25 of 2015.
[121] National Treasury, 2015, 11.

b) Any gains which resulted in the instance where the trust sold the shares and vested the profits in the participants, constituted a section 8C gain in the hands of the participants as the gain qualified as a section 8C instrument by virtue of being a beneficial interest in the trust.

4. Paragraph 80(2A)[122] was inserted which intended to clarify that where the employee SIT disposes of the shares held in the trust and subsequently vests the profits in the hands of the participants, the provisions of paragraph 80(2)[123] will not apply if the amount is taken into account for purposes of section 8C in the hands of the participants.[124]

The above amendments, though made for purposes of addressing an anomaly in the ITA, were to a large extent unsuccessful, as is evidenced by the further amendments to the ITA which followed.

During 2016, further amendments were introduced into section 8C[125] and section 10(1)(k)(i)[126] by way of the Taxation Laws Amendment Act 15 of 2016 so as to address situations where restricted equity instruments allocated to employees are liquidated in return for an amount equal in value to the shares which qualify as a dividend paid to employees, rather than as shares with embedded gain.

The amendment resulted in the characterisation of amounts received by or accrued to participants through the liquidation of restricted equity instruments as remuneration where the liquidation occurs where the restrictions are still in place. The amounts paid to participants will therefore be included in the employee's gross income and will be taxed at the employee's marginal rate.[127]

[122] Amended by section 123(1)(b) of the Taxation Laws Amendment Act 25 of 2015.
[123] Paragraph 80(2) states that any capital gain determined in respect of the disposal of an asset by a trust in a year of assessment during which the trust beneficiary who is a resident has a vested interest or acquires a vested interest in the capital gain, but not the asset, the disposal of which gave rise to the capital gain, the portion or whole of the gain that vests must be disregarded for CGT purposes in the hands of the trust. The gain is attributed to the beneficiary and must be taken into account for purposes of calculating the aggregate capital gain of the beneficiary in whom it vests.
[124] National Treasury, 2015, 11.
[125] Amended by section 13(1) of the Taxation Laws Amendment Act 15 of 2016.
[126] Amended by section 23(1)(d) of the Taxation Laws Amendment Act 15 of 2016.
[127] National Treasury, 2017, 13.

Following the above amendments, it soon became apparent that the 2015 amendments to the ITA in the form of paragraph 80(2A) overlapped with the 2016 amendments. Section 8C(1A) was aimed at ensuring that the capital gain received by employees who are holders of restricted equity instruments are taxed as normal income, whereas paragraph 80(2A) was aimed at preventing the "conduit principle" in respect of gains arising on the disposal of a trust asset which are vested in the participants, thereby resulting in the capital gains arising from a disposal of trust assets to participants being taxable in the hands of the trust and not in the hands of the participant where the gain is taxed as income in the hands of the participant for purposes of section 8C.[128]

The interaction between these provisions caused unintended double taxation due to a capital gain arising from the disposal of shares by a trust being subject to CGT in the hands of the trust, and capital gains arising from the liquidation of a restricted share being subject to income tax in the hands of the participant.

3.4.3 Most recent amendments

The Taxation Laws Amendment Act 17 of 2017 attempted to rectify this unintended anomaly during the 2017 legislative cycle through *inter alia* the introduction of paragraph 64E of the Eighth Schedule; further amendments to paragraph 80(2) and the deletion of paragraph 80(2A). While paragraph 80(1) remained unchanged during the 2017 legislative cycle, the author has identified two anomalies that persist in the current wording of the anti-avoidance provisions in the Eighth Schedule and which impact on employee share incentive schemes operating through SITs. As a result hereof, an in-depth exploration of the above amendments and the perceived anomalies is set out in Chapter 4 below, together with comments on the effectiveness of these provisions in achieving the purpose for which they were intended.

3.5 Conclusion

This chapter provided the reader with the history and original purpose behind the implementation of the key anti-avoidance provisions contained in sections 8C, 10(1)(k)(i) and the Eighth Schedule of the ITA which impacts on the tax consequences of employee

[128] Ibid.

share incentive schemes operating through SITs. It is clear that the aim of these provisions is to prevent income derived from the vesting of restricted equity instruments being classified as dividends or capital gains which are taxed at a lower rates.

The anti-avoidance provisions discussed in this chapter have had a widespread impact on the tax consequences of employee share incentive schemes, particularly those schemes operated through a SIT. The provisions contained in section 8C and section 10(1)(k)(i) appear to effectively fulfil their intended function, i.e. to prevent income derived from the vesting of restricted equity instruments as being classified as dividend and no further amendments to the ITA are deemed necessary in respect of these provisions.

It is concluded that the amendments to the ITA during the 2015, 2016 and 2017 legislative cycles resulted in the creation of unintended anomalies with regards to employee share incentive schemes operating through SITs. These anomalies include double taxation which arose due to the 2015 and 2016 amendments in respect of the interaction between section 8C(1A) and the Eighth Schedule.

The legislature attempted to address this specific anomaly during the 2017 legislative cycle has by removing paragraph 80(2A), amending paragraph 80(2) and by introducing paragraph 64E.[129] There are however perceived anomalies which remain (and which will be discussed in Chapter 4) which should be addressed in order to ensure consistent application of the ITA to employee share incentive schemes operating through SITs.

[129] National Treasury, 2017, 12-14.

Chapter 4: Current anti-avoidance provisions of the Eighth Schedule: Do anomalies remain and how could these anomalies be addressed?

4.1 Introduction

The 2017 legislative cycle resulted in further amendments to the Eighth Schedule of the ITA in the form of paragraphs 64E and 80(2) for purposes of addressing the anomaly of unintended double taxation due to a capital gain arising from the disposal of shares by a SIT being subject to CGT in the hands of the SIT, and capital gains arising from the liquidation of a restricted share being subject to income tax in the hands of the participant.

This chapter aims to:

1. conduct an analysis of the perceived anomalies that still persist in relation to the CGT implications of employee share incentive schemes operating through share incentive trusts ("SITs"); and
2. provide recommendations of possible amendments which could be made to the anti-avoidance provisions in the Eighth Schedule to address these anomalies.

In order to satisfy the above objectives, this chapter commences with an analysis of the current wording of paragraphs 80(1), 80(2) and 64E of the Eighth Schedule in order to highlight the creation of the perceived anomalies and includes comments on the effectiveness of these provisions in achieving the aim for which they were implemented.

The implications of these provisions for common employee share incentive scheme operating through SITs are examined by way of a case study in order to illustrate how participants under such schemes will be taxed. Recommendations on addressing these anomalies are offered. Finally, this chapter also provides an overview of National Treasury's response to these anomalies as well as a brief discussion of the proposed 2018 amendments to these provisions and whether these proposed amendments will address the perceived anomalies so as to determine whether South Africa should consider making further amendments to the ITA.

4.2 Perceived current anomalies found in the Eighth Schedule

4.2.1 Paragraph 80(1)

Paragraph 80(1) contains the general rule with regards the tax position where a trust distributes an asset to a beneficiary: The distribution of an asset by the trust to its beneficiary constitutes a disposal for purposes of paragraph 11 of the Eighth Schedule. The capital gain arising from the disposal of that asset is attributed to and taxable in the hands of the beneficiary as a connected person in relation to the trust.

Paragraph 80(1) currently reads as follows:[130]

> *"80. Capital gain attributed to beneficiary. – (1) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary (**other than** any person contemplated in paragraph 62(a) to (e)) or a person who acquires that asset as an **equity instrument as contemplated in section 8C(1)**) who is a resident, that gain –*
>
> *(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and*
>
> *(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of."*

It is notable that this paragraph explicitly excludes instances where the asset which is disposed of to a trust beneficiary constitutes an equity instrument for purposes of section 8C of the ITA.[131]

Based on the wording of paragraph 80(1) and the explicit exclusion of section 8C instruments from the attribution provision, it would mean that, where a SIT disposes of a qualifying equity instrument to a participant, the capital gain which arises from the disposal will remain taxable in the hands of the SIT at an 80% inclusion rate as it cannot be attributed to the participant. The SIT will therefore have to account for the capital gain

[130] For emphasis, the problematic wording in this paragraph has been indicated in bold type.
[131] SARS, "Comprehensive Guide to Capital Gains Tax 2018", accessed on 25 October 2018, http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20-%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf,582-583.

under paragraph 11 upon the vesting of the equity instrument.[132] Furthermore, upon vesting of these equity instruments in the participant, these equity instruments will be taxed as income in the participant's hands.[133]

The wording of paragraph 80(1) therefore results in there being double taxation where an employee SIT vests the actual underlying equity instruments in participants.

4.2.2 Paragraph 80(2)

In addition and in contrast to the position where an employee SIT vests the actual equity shares in the participants, one must pay particular notice to the wording of paragraph 80(2). This paragraph has been amended numerous times, the latest of which was during 2017. This amendment, together with the introduction of paragraph 64E (see discussion below), was intended to rid the Eighth Schedule of the unintended anomaly of double taxation which was unintentionally caused due to an overlap in the 2015/2016 amendments.

The current wording of this subparagraph, as amended by section 75(1)(a) of the Taxation Laws Amendment Act 17 of 2017, is set below:[134]

> *"(2) Subject to paragraphs 64E, 68, 69**[,]** and 71 **[and 72],** where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e)) who is a resident has a vested **[interest]** right or acquires a vested **[interest]** right (including **[an interest caused]** a right created by the exercise of a discretion) **[in]** to an amount derived from that capital gain but not **[in]** to the asset, the disposal of which gave rise to the capital gain, **[the whole or the portion]** so much of the capital gain **[so vested]** as is equal to the amount to which that trust beneficiary is entitled in terms of that right –*

[132] SARS, 582-583.
[133] Ibid.
[134] For purposes of clarity, the current wording of the section is presented as contained in section 75(1)(a) of the Taxation Laws Amendment Act. As such, words in bold in square brackets indicate omissions from existing enactments, whereas words which are underlined indicate insertions into existing enactments.

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or capital loss of the beneficiary ***[in whom the gain vests]*** *<u>who is entitled to that amount</u>."*

Paragraph 80(2) provides that, where a trust asset is disposed of by the trust and the beneficiary acquires a vested right to the amount arising from the capital gain on the disposal, the trust must disregard the amount for CGT purposes and the amount must be taken into account in determining the participant's aggregate capital gain.[135]

What is critical to bear in mind, however, is that the interaction of this anti-avoidance provision with those contained in section 8C of the ITA. Section 8C includes all equity instruments which fall within the ambit of section 8C in the remuneration of the participant which is in then taxed as part of his taxable income at his marginal rate. This would include the gains received by the participant upon the disposal of the shares. Without the amendment to paragraph 80(2) which caused this paragraph to be subject to the newly introduced paragraph 64E,[136] a participant would have been liable to pay both income tax on the amount received on the value of the equity instruments, as well as CGT as the capital gain is attributed to the participant in terms of paragraph 80(2).

4.2.3 Introduction of paragraph 64E to the Eighth Schedule

Section 64E was introduced into the ITA by section 74(1) of the Taxation Laws Amendment Act 17 of 2017 and reads as follows:

> *"64E. Disposal by trust in terms of share incentive scheme. – Where a capital gain is determined in respect of the disposal of an asset by a trust and a trust beneficiary has a vested right to an amount derived from that capital gain, that trust must disregard so much of that capital gain as is equal to that amount if that amount must in terms of section 8C be –*

[135] SARS, 587.

[136] This point is discussed and emphasised in the Explanatory Memorandum to the Taxation Laws Amendment Bill 2017. These two paragraphs were introduced into the ITA simultaneously, with application in respect of amounts received or accrued from 1 March 2017 onwards.

(a) included in the income of that trust beneficiary as an amount received or accrued in respect of a restricted equity instrument; or

(b) taken into account in determining the gain or loss in the hands of that trust beneficiary in respect of the vesting of a restricted equity instrument."

This section effectively provides that, where a SIT disposes of equity instruments in terms of an employee share incentive scheme, the SIT will disregard so much of the capital gain equal to the amount to which the participants have a vested by virtue of 64E(a), thereby ensuring that no capital gain is attributed the participant in terms of section 80(2).[137]

Therefore, in the instances where an employee share incentive scheme operating through a SIT disposes of the shares held in SIT and vests the gains received in the participants, the amounts received by the participants will not be taxable as a capital gain in the hands of the participants, but will only be subject to income tax in the participant's hands at his or her marginal rate in terms of section 8C.[138]

The implications of these provisions are illustrated in the case study below.

4.2.4 Case study

4.2.4.1 Common facts

Mr X, a South African resident is an employee of ABC Limited, a South African resident company. ABC Limited's remuneration philosophy is aimed at attracting and retaining talented employees whilst at the same time driving the growth of the company's share price. All employees are awarded annual grants of share appreciation rights ("SARs"). ABC Limited's SAR Plan operates through a SIT which was established for purposes of administering the Plan.

The SIT grants Mr X 100 SARs in ABC Limited on 1 September 2013, with the value of an ABC Limited Share being R50. The vesting of the SARs is subject to Mr X remaining in the employ of ABC Limited for a period of three years from the award date. Upon the

[137] SARS, 504.
[138] Ibid.

vesting of the SARs, Mr X has a further two year period during which to exercise his SARs.

Mr X's SARs vest on 1 September 2016. Mr X decides to exercise his SARs on 1 July 2017 at which time the share price of ABC Limited is R100.

4.2.4.2 Option 1 – Equity-settlement

The ABC SAR Plan is an equity-settled plan and Mr X is therefore entitled to receive ABC Limited shares to the value of the difference between the share price on the award date and on the exercise date. The SIT settles 500 shares[139] to Mr X.

Income Tax consequences under the current anti-avoidance provisions:

Mr X receives the SAR by virtue of his employment with ABC Limited. The SAR qualifies as a restricted equity instrument in terms of section 8C(7) until such time as it is exercised as it constitutes a contractual right of which the value is determined directly with reference to a share in ABC Limited, and the vesting of the SAR is subject to the satisfaction of certain vesting conditions.

On exercise of the SARs, Mr X will become unconditionally entitled to the settlement of his award in shares by the SIT and his award will be deemed to vest for purposes of section 8C(3)(b)(i). A capital gain will be determined in respect of the vesting of the shares in Mr X by the SIT and the gain must, in terms of the ITA be treated as follows:

1. The gain arising on the vesting of the shares in Mr X must be taxed in the SIT as the gain is not attributed to Mr X in terms of paragraph 80(1) of the Eighth Schedule and paragraph 80(1) is not subject to paragraph 64E; AND
2. The gain must be included in Mr X's gross income in terms of section 8C(1)(a)(i) as a gain received in respect of a restricted equity instrument acquired by Mr X by virtue of his employment.

In essence, double taxation will occur as is illustrated above.

[139] The difference between the share price on award and on exercise is R50. As such, Mr. X is entitled to shares to the value of R5000 (100 SARs x R50). This results in 100 shares (R5000 / R100 per share) being settled to Mr. X.

4.2.4.3 Option 2 – Cash-settlement

The ABC SAR Plan provides for cash settlement of awards. On exercise of the SARs the SIT disposes of the shares to a third party and vests the proceeds of R5000[140] in Mr X (as a participant with a vested right to the amount derived from the capital gain on the disposal of the shares) in lieu of the shares.

Income Tax consequences under the current anti-avoidance provisions:

As is the case in Option 1 above, Mr X receives restricted equity instruments in the form of SARs by virtue of his employment with ABC Limited. On exercise of the SARs, Mr X will become unconditionally entitled to the settlement of his award in cash and his award will be deemed to vest for purposes of section 8C(3)(b)(i). A capital gain will be determined in respect of the disposal of the shares and so much of the gain as is equal to the amount derived from the capital gain and to which Mr X is entitled will vest in him.

In terms of the ITA, the gain will be treated as follows:

1. The gain of R5000 must be included in Mr X's gross income in terms of section 8C(1A) as a gain received in respect of a restricted equity instrument acquired by Mr X by virtue of his employment; and
2. In terms of paragraphs 80(2) and 64E, the SIT must disregarded the R5000 gain as an equivalent amount is included in Mr X's income in terms of section 8C.

Option 2 would therefore be the most tax efficient.

4.2.5 Conclusion: Effectiveness of the anti-avoidance provisions

Although the provisions appear to be successful in preventing the avoidance of tax by ensuring that amounts are correctly included as income in the hands of employee beneficiaries, paragraphs 80(1) and 64E remain problematic.

As is clear from the above case study, equity-settled schemes are consequently rendered less tax efficient when compared to cash-settled schemes as the gain arising from the disposal of the shares from the SIT to the employee will result in double taxation as the

[140] The difference between the share price on award and on exercise is R50. As such, Mr. X is entitled to the value of R5000 (100 SARs x R50).

gain will be taxed as a capital gain in the hands of the SIT and as income in the hands of the participant. In contrast, where the underlying shares are disposed of by the SIT and the profits are vested in the participants, the gain will only be taxed as income in the hands of the employees. Effectively, this means that the following two unintended anomalies result from the current wording of the anti-avoidance provisions in the ITA:

1. Double taxation where the SIT vests the actual underlying equity instruments in the participant; and
2. Unequal tax treatment of employee share incentive schemes operating through SITs on the basis of how the award is settled.

Therefore, although National Treasury appears to have succeeded in addressing the anomaly of double taxation resulting from the 2015/2016 amendments to the ITA, a the above similar anomaly of double taxation persists and an additional anomaly has inadvertently been created.

4.3 Response documents to Treasury

It is worth noting that the above anomalies were highlighted in presentations to National Treasury during the 2017 legislative cycle in response to the proposed amendments in the Taxation Laws Amendment Bill 2017.

The Final Response Document on Taxation Laws Amendment Bill, 2017 and Tax Administration Bill, 2017, sets out the purpose of the proposed amendments to the ITA, being a clarification of the interaction of the provisions of section 8C(1A) and the provisions of the Eighth Schedule by inserting a new paragraph 64E in the Eighth Schedule which makes provision for amounts that are included in the employees' taxable income in terms of the anti-avoidance provisions of section 8C(1A) to be disregarded for CGT purposes.[141]

The following comment as extracted from submissions to National Treasury on the above proposal is set out in the Final Response Document: [142]

[141] National Treasury, Final Response Document, paragraph 2.3 on 12.
[142] Ibid.

"Paragraph 80(1) of the Eighth Schedule should also be amended to remove the exclusion of section 8C equity instruments and be made subject to paragraph 64E of the Eighth Schedule, which should be amended to also cater for distributions of equity instruments by an employee share trust."

National Treasury acknowledged the above comment and suggested amendments in respect of the proposed amendments contemplated in the Taxation Laws Amendment Bill by reply of "Noted",[143] but took no action to implement these suggested amendments as is evident from the resulting current wording of the anti-avoidance provisions. To date, no explanation for the lack of actions appears to have been provided.

4.4 Addressing the remaining anomalies: suggested changes to current wording of anti-avoidance provisions

In order to address the above two anomalies, the following amendments to the ITA are suggested:[144]

4.4.1 Paragraph 80(1)

Paragraph 80(1) should be amended and be made subject to section 64E. The amendments should further include removing the exclusion of section 8C equity instruments from this paragraph. The amendment paragraph could read as follows:

*80. (1) Subject to paragraphs 64E, 68, 69, 71 and 72, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e**)) [or a person who acquires that asset as an equity instrument as contemplated in section 8C(1)]**) who is a resident, that gain –*

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

[143] Ibid.

[144] For ease of reference, the proposed amendments set out in this section follow the style of the Taxation Laws Amendment Acts in respect of highlighting omissions from and insertions to the existing provisions.

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of.

The above wording will ensure that, where an employee SIT vests the actual underlying shares in the employee beneficiaries, the gain which arises from the disposal of the shares by the SIT will be disregarded in the hands of the SIT, but rather be taken taxed as income in the hands of the participant. These proposed amendments, together with the suggested amendments to paragraph 64E below will ensure that employee SITs which dispose of the actual underlying equity instruments to the employee beneficiaries in the vesting of the instruments are treated the same for tax purposes as schemes where the shares are sold and the profits are vested in the employee beneficiaries.

4.4.2 Paragraph 64E

Paragraph 64E, in its current form, provides that a trust must disregard so much of the capital gain as is equal to the amount derived from the capital gain which is determined in respect of the disposals of an asset by the trust to a third party and which amount must be included in the participant's income for purposes of section 8C. This paragraph does not at present allow for a capital gain to be disregarded where it is determined in respect of the disposal of the trust assets by the vesting thereof in the trust beneficiaries. Following the suggested amendment to paragraph 80(1) above, paragraph 64E should be amended so as to also provide for the distribution of equity instruments by the SIT.

The following wording is proposed for paragraph 64E:

64E. Disposal by trust in terms of share incentive scheme. –

(1) Where a capital gain is determined in respect of <u>the vesting by a trust of an asset in a trust beneficiary, or where a capital gain is determined in respect of</u> the disposal of an asset by a trust and a trust beneficiary has a vested right to an amount derived from that capital gain, that trust must disregard so much of that capital gain as is determined in respect of that disposal and must in terms of section 8C be –

(c) Included in the income of that trust beneficiary as an amount received or accrued in respect of a restricted equity instrument; or

(d) Taken into account in determining the gain or loss in the hands of that trust beneficiary in respect of the vesting of a restricted equity instrument.

4.5 Latest proposed amendments under the Taxation Laws Amendment Bill, 2018

The Taxation Laws Amendment Bill for 2018 was released for public comment during July of 2018. As was the case with the Taxation Laws Amendment Bill 2017, it appears that National Treasury has not taken the steps necessary to address the remaining anomaly as the suggested changes contained in the Final Response Document are not proposed for paragraphs 64E and 80(1).

It is instead proposed in section 86(1) that paragraphs 80(1) and 80(2) be substituted by the following paragraphs::

"80(1) "Subject to paragraphs 68, 69 and 71 ***[and 72],*** *where a trust vests an asset in a beneficiary of that trust (other than any person contemplated in paragraph 62(a) to (e) or a person who acquires that asset as an equity instrument as contemplated in section 8C(1)) who is a resident and determines a capital gain in respect of that disposal or, if that trust is not a resident, would have determined a capital gain, in respect of* ***[the vesting by a trust of an asset in a trust beneficiary, that gain]*** *that disposal had it been a resident—*

(a) that capital gain must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) that capital gain or the amount that would have been determined as a capital gain must be taken into account as a capital gain for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of."

"80(2) Subject to paragraphs 64E, 68, 69 and 71, where a trust determines a capital gain (or, if that trust is not a resident, would have determined a capital gain had it been a resident) in respect of the disposal of an asset ***[by a trust]*** *in a year of assessment during which a* ***[trust]*** *beneficiary of that trust (other*

than any person contemplated in paragraph 62(a) to (e)) who is a resident has a vested right or acquires a vested right (including a right created by the exercise of a discretion) to an amount derived, directly or indirectly, from that capital gain or from the amount that would have been determined as a capital gain had that trust been a resident but not to the asset disposed of, ***[the disposal of which gave rise to the capital gain,]*** *an amount that is equal to so much of* ***[the capital gain as is equal to]*** *the amount to which that* ***[trust]*** *beneficiary of that trust is entitled in terms of that right as consists of or is derived, directly or indirectly, from—*

(a) that capital gain must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) that capital gain or the amount that would have been determined as a capital gain must be taken into account as a capital gain for the purpose of calculating the aggregate capital gain or aggregate capital loss of ***[the]*** *that beneficiary* ***[who is entitled to that amount]****."*

The Explanatory Memorandum accompanying the Taxation Laws Amendment Bill 2018 provides a brief explanation of the proposed changes to the above paragraphs. It states that the government has been concerned that the Controlled Foreign Company (hereafter "CFCs") rules do not sufficiently capture foreign companies which are held by interposed foreign trusts. Amendments were made to these CFC rules during the 2017 legislative cycle to extend the application thereof to foreign companies held through foreign trusts whose finanical results form part of the consolidated financial statements of a group of which the parent company is a South African resident company.[145] These amendents did not address the situation where a South African resident has an indirect interest in a foreign company through a foreign trust.[146]

[145] National Treasury, "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018", 39-40, accessed 1 October 2018, http://www.treasury.gov.za/public%20comments/TLAB%20and%20TALAB%202018%20Draft/2018%20Draft%20Explanatory%20Memorandum%20on%20the%202018%20draft%20TLAB.pdf

[146] Ibid.

Instead of addressing the perceived anomalies, the proposed changes are aimed at closing the perceived loophole in the current tax legislation regarding the use of trusts to defer tax or recharacterise the nature of income.[147] As part of addressing this loophole, the following is proposed:

> "*D. Disregarding participation exemption in respect of capital gains derived from the sale of foreign shsares for purposes of attribution of capital gain in terms of paragraph 80 of the Eighth Shcedule to the Act*
>
> In determining an amount of capital gain that should be attributed in terms of paragraph 80 of the Eighth Schedule to the Act, in the hands of a resident beneficiary, it is proposed that the participation exemtpion as contemplated in paragraph 64B of the Eighth Schedule to the Act in respect of capital gains derived from the sale of shares held by the foreign trust (in which a beneficiary is a resident) in a foreign company should be disregarded."[148]

As noted in Chapter 1, the scope of this disseration is limited to South African trusts and beneficiaries, but it is worth noting that the above proposed amendments appear to have the following effects:

1. In respect of paragraph 80(1), the amendment would result in South African resident beneficiaries being liable for capital gains which arise due to the vesting an asset in the resident beneficiary, irrespective of whether the asset is vested in the beneficiary by a foreign trust or a South African resident trust.
2. Paragraph 80(2) would result in South African resident beneficiaries being liable for capital gains which is detemrined in respect of a disposal of an asset by either a foreign trust or a South African resident trust and in which the beneficiary has a vested right to the amount derived from the capital gain.

As such, it appears that for purposes of paragraph 80, the tax consequences in respect of foreign trusts and South African trusts would be similar. A deeper analysis of the proposed amendmends and the CFC rules is however required to determine the full

[147] Ibid.
[148] Ibid, 40.

effects of these amendments and whether the amendments would succeed in closing the identified loophole.

4.6 Conclusion

This chapter analysed the current wording of the anti-avoidance provisions impacting on SITs as contained in Eighth Schedule and concluded that, while these provisions appear to be successful in preventing the avoidance of tax by ensuring that amounts are correctly characterised as income in the hands of employee beneficiaries, paragraphs 80(1) and 64E remain problematic. The following two anomalies persist in relation to the CGT implications of employee share incentive schemes operating through SITs:

1. Where an employee SIT disposes of an actual share to a participant, the shares will be subject to capital gains tax in the SIT, as well as to income tax in terms of section 8C in the hands of the participant thereby resulting in double taxation.
2. In contrast, however, the participant will only be liable for income tax in the case where the participant receives an amount equal in value to the shares which have been disposed of by the SIT prior to the vesting of the amount in the participant. This results in the unequal tax treatment of employee share incentive schemes operating through SITs in respect of the settlement mechanisms used.

In addition to the above tax consequences impacting on participants to employee share incentive schemes operating through a SIT, it is important to note the widespread effect of these provisions. These anomalies are of particular concern for BBBEE schemes. These schemes are typically set up so that qualifying participants receive actual equity shares at a future date, thereby giving these participants the opportunity to become shareholders in the company. This is further required for a company to obtain the relevant points required for the company's BBBEE scorecard. In light of the above anomalies, these schemes would be less tax efficient than a scheme in which the underlying shares are sold by the SIT and the gains are vested in the participants, as the BBBEE SIT will be required to pay CGT on the shares vested in the participants. This could be a potential deterrent for the implementation of such schemes, as well as for the continuation of existing schemes in their current form.

It is submitted that the above anomalies could easily be addressed, as is clear from the Final Response Document setting out submissions to National Treasury which indicates the suggested changes to the above paragraphs. In spite of this, no steps seem to have been taken by National Treasury to rectify and address this anomaly as is also evident from the proposed amendments in the Taxation Laws Amendment Bill 2018. Recommendations on possible amendments to these provisions for mitigating the anomalies are provided.

In conclusion, it is notable that the current wording of the above anti-avoidance provisions do not have retrospective application. As such, these provisions are only applicable as of 1 March 2017 onwards. This could potentially lead to uncertainty with regards to the tax treatment of employee share incentive awards where the underlying shares are vested in the participants to the scheme.

Chapter 5: Conclusion

5.1 Introduction

Over the past decade, anti-avoidance measures were introduced into the ITA to specifically regulate the tax consequences of employee share incentive schemes operating through South African resident share incentive trusts ("SITs"). The anti-avoidance provisions impacting on employee share incentive schemes operating through SITs as contained in section 8C, section 10(1)(k)(i) and the Eighth Schedule to the ITA have been a particular focus of National Treasury. Amendments were made to the ITA to refine these anti-avoidance provisions and to address several unintended anomalies, including the anomaly that the disposal of an equity instrument by a trust to a qualifying participant constitutes a non-event for capital gains tax ("CGT") purposes in terms of the Eighth Schedule.[149]

In light hereof, this dissertation aimed to achieve the following research objectives:

1. To consider the most prevalent employee share incentive schemes in South Africa, with a focus on schemes which utilise SITs, in order to provide the necessary context for the discussions in chapters 3 and 4 with regards to the anti-avoidance provisions in section 8C, section 10(1)(k)(i) and the Eighth Schedule which impact on employee share incentive schemes operating through SITs.
2. To explore the development of these anti-avoidance provisions impacting on employee share incentive schemes operating through SITs over the last decade, with a focus on identifying anomalies created by and/or addressed by amendments to these provisions.
3. To conduct an analysis of the perceived anomalies that still persist in relation to the CGT implications of employee share incentive schemes operating through SITs, including recommendations of possible amendments which could be made

[149] National Treasury, 2015, 10 and the Taxation Laws Amendment Act 25 of 2015 at section 123; and the Taxation Laws Amendment Act 17 of 2017 which amendment paragraphs 80(1), 80(2), 80(2A) and 64E of the Eighth Schedule. See also section 13(1) of Taxation Laws Amendment Act 15 of 2016 which amended section 8C(1A).

to the anti-avoidance provisions in the Eighth Schedule to address these anomalies.

In order to meet the above research objectives, this dissertation discussed (a) the common structures of employee share incentive schemes operating through SITs in Chapter 2; (b) the anti-avoidance provisions impacting on employee share incentive schemes operating through SITs in Chapter 3; and (c) the current anti-avoidance provisions of the Eighth Schedule in Chapter 4. A summary of the findings of this study is set out below.

5.2 Summary of findings

Employee share incentive schemes are common in South African companies.[150] Share incentive schemes aimed at the remuneration of executives and employees were originally introduced as a mechanism through which companies attempted to counter the high levels of individual taxes.[151] Over the years, different types of schemes have developed so as to address the various needs of companies and to mitigate the changes in income tax legislation[152] impacting upon the operation of these schemes.[153]

Chapter 2 explored the rationale behind companies adopting share incentive schemes and the key variable features of employee share incentive schemes. It also identified and set out the salient features of the most prevalent employee share incentive schemes in South Africa which typically make use of a SIT. It was concluded that the most prevalent employee share incentive schemes which are run through SITs are share purchase schemes, share option schemes, deferred delivery schemes and phantom share schemes and BBBEE schemes. This chapter provided the necessary context for the discussions in chapters 3 and 4 with regards to the anti-avoidance provisions in section 8C, section 10(1)(k)(i) and the Eighth Schedule which impact on employee share incentive schemes operating through SITs.

[150] Isaacman, 11.
[151] M Stafford, 2005.
[152] Refer to the discussion in chapter 3 on the various changes to the ITA impacting upon such schemes.
[153] Isaacman, 11; Jonas, 16.

Chapter 3 aimed to explore the development of these anti-avoidance provisions impacting employee share incentive schemes operating through SITs over the last decade, with a focus on identifying anomalies created by and/or addressed by the amendments to these provisions. It provided the reader with the history and original purpose behind the implementation of the key anti-avoidance provisions contained in sections 8C, 10(1)(k)(i) and the Eighth Schedule of the ITA which impacts on the tax consequences of employee share incentive schemes operating through SITs. It was determined that the aim of these provisions was to prevent income derived from the vesting of restricted equity instruments being classified as dividends or capital gains which are taxed at a lower rates

It was furthermore concluded that the anti-avoidance provisions contained in section 8C and section 10(1)(k)(i) have had a widespread impact on the tax consequences of employee share incentive schemes, particularly those schemes operated through a SITs. The aforementioned provisions appear to effectively fulfil their intended function, i.e. to prevent income derived from the vesting of restricted equity instruments as being classified as dividend.

In respect of the anti-avoidance provisions contained in the Eighth Schedule, it was concluded that the amendments to the ITA during the 2015, 2016 and 2017 legislative cycles resulted in the creation of unintended anomalies with regards to employee share incentive schemes operating through SITs. These anomalies included double taxation which arose due to the 2015 and 2016 amendments in respect of the interaction between section 8C(1A) and the Eighth Schedule. It was concluded that anomalies persist in relation to the CGT treatment of SITs as a result of the current wording of the anti-avoidance provisions contained in the Eighth Schedule. In light hereof, a detailed discussion in respect of the anti-avoidance provisions contained in the Eighth Schedule and impacting on SITs was discussed separately in Chapter 4.

Chapter 4 aimed to conduct an analysis of the perceived anomalies that still persist in relation to the CGT implications of employee share incentive schemes operating through SITs. It further aimed to provide recommendations of possible amendments which could be made to the anti-avoidance provisions in the Eighth Schedule to address these anomalies.

The current wording of the anti-avoidance provisions impacting on SITs as contained in Eighth Schedule was analysed and it was concluded that, while these provisions appear to be successful in preventing the avoidance of tax by ensuring that amounts are correctly characterised as income in the hands of employee beneficiaries, paragraphs 80(1) and 64E remain problematic. It was further concluded that the following two anomalies persist in relation to the CGT implications of employee share incentive schemes operating through SITs:

1. Where an employee SIT disposes of an actual share to a participant, the shares will be subject to capital gains tax in the SIT, as well as to income tax in terms of section 8C in the hands of the participant thereby resulting in double taxation.
2. In contrast, however, the participant will only be liable for income tax in the case where the participant receives an amount equal in value to the shares which have been disposed of by the SIT prior to the vesting of the amount in the participant. This results in the unequal tax treatment of employee share incentive schemes operating through SITs in respect of the settlement mechanisms used.

Chapter 4 further highlighted the fact that the anomalies are of particular concern for BBBEE schemes. These schemes are typically set up so that qualifying participants receive actual equity shares at a future date, thereby giving these participants the opportunity to become shareholders in the company. This is further required for a company to obtain the relevant points required for the company's BBBEE scorecard. In light of the above anomalies, these schemes would be less tax efficient than a scheme in which the underlying shares are sold by the SIT and the gains are vested in the participants, as the BBBEE SIT will be required to pay CGT on the shares vested in the participants. This could be a potential deterrent for the implementation of such schemes, as well as for the continuation of existing schemes in their current form.

It was submitted that the perceived anomalies which persist in relation of the CGT treatment of SITs could easily be addressed, as is clear from the Final Response Document setting out submissions to National Treasury which indicates the suggested changes to the above paragraphs. In spite of this, no steps seem to have been taken by National Treasury to rectify and address this anomaly as is also evident from the proposed

amendments in the Taxation Laws Amendment Bill 2018. Recommendations on possible amendments to these provisions for mitigating the anomalies were provided.

In conclusion, Chapter 4 noted that the current wording of the above anti-avoidance provisions do not have retrospective application. As such, these provisions are only applicable as of 1 March 2017 onwards. This could potentially lead to uncertainty with regards to the tax treatment of employee share incentive awards where the underlying shares are vested in the participants to the scheme.

In light of the findings of this study set out above, it is submitted that this dissertation met the research objectives set out in Chapter 1.

5.3 Recommendations

The anti-avoidance provisions in the Eighth Schedule remain problematic in that the wording of and interaction between these anti-avoidance provisions result in unintended double taxation occurring where an equity-settled employee share incentive scheme is operated through a SIT. This outcome is problematic as it would mean that such schemes are less tax efficient than schemes were the underlying shares are sold and the profits vested in the employee participants, thereby resulting in unequal tax treatment based on the methods of settlement. The amendments have to date not succeeded in addressing the anomalies and closing the loopholes as was originally intended.

It is therefore recommended that paragraphs 80(1) and 64E of the Eighth Schedule be amended as per the suggestion set out in Chapter 4 above in order to ensure that employee beneficiaries to employee share incentive schemes operating through SITs are treated equally irrespective of whether the scheme is equity-settled or cash settled.

5.4 Future areas of study

The scope of this dissertation was limited to exploring the impact of select anti-avoidance provisions on employee share incentive schemes operating through SITs. The lack of retrospective application of the anti-avoidance provisions was not explored in any significant detail, and the impact thereof on employee share incentive schemes could potentially be an area for further study.

The anti-avoidance provisions relating to dividends were limited to those paid to participants to employee share incentive schemes operating through SITs. The full impact of these provisions on all employee share incentive schemes should be explored in order to determine whether the provisions, as they currently stand, are sufficiently preventing the mischiefs as intended.

(18, 298 words, excluding footnotes)

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