

Dividend payments from employee share scheme trusts

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Abstract

In the past, there has been confusion regarding the taxation of dividends received from employee share scheme trusts. Conflicting interpretations of the definitions in section 8C and certain provisions of 10(1)(k) of the Income Tax Act No. 58 of 1962 (ITA) have caused administrators of these schemes to treat the taxation of dividends in various ways.

Section 10(1)(k)(i)(ii) was introduced in the Taxation Laws Amendment Act (TLAA) of 2013 to address the situation where employers are disguising salaries and bonuses as dividend payments to members of employee share scheme trusts. The intention behind this new section 10(1)(k)(i)(ii) is quite clear but it is not entirely certain whether it is having the desired effect as there is still uncertainty around the treatment of dividends from unrestricted equity instruments.

The Davis Tax Committee (DTC) published recommendations on the taxation of trusts in its first interim report on estate duty. These recommendations could further complicate matters and have significant tax implications for all the parties involved in these employee share scheme trusts.

To try and understand the uncertainty around these dividend payments an analysis was conducted on section 10(1)(k)(i)(dd) and 10(1)(k)(i)(ii) of the ITA. It was also necessary to look at the different types of employee share schemes that are available and also the nature of dividends, dividends withholding tax (DWT) and capital gains tax (CGT). Section 8C and the definitions therein were also analysed to understand the taxation of taxpayers on vesting of equity instruments. A brief look at the treatment of dividend payments from United Kingdom employee share scheme trusts also provided some useful context from an international perspective.

Two case studies were conducted to analyse the overall tax effect based on the current tax legislation and also taking into consideration the recommendations made by the first DTC Report.

Abbreviations and glossary

CGT	Capital Gains Tax
DTA	Double Tax Agreement
DTC	Davis Tax Committee
DWT	Dividend Withholding Tax
ITA	Income Tax Act No. 58 of 1962
PAYE	Pay As You Earn
SARS	South African Revenue Service
SIT	Share Incentive Trust
TLAA	Taxation Laws Amendment Act
TLAB	Taxation Laws Amendment Bill

Contents

1	Introduction	1
1.1	Title of this dissertation	1
1.2	Background and purpose of this study	1
1.3	Research objective	3
1.4	Research method	4
1.5	Scope and limitations of this study	4
1.6	Structure of this paper	4
2	Analysis of Trusts and Employee Share Schemes	6
2.1	Trusts	6
2.1.1	Bewind trust	8
2.1.2	Ownership trust	9
2.2	Conduit principle	9
2.2.1	Section 25B	10
2.2.2	Section 7	11
2.3	Employee share schemes	12
2.3.1	Types of share schemes	13
2.3.2	Share incentive trust	15
3	Implications of section 8C on employee share scheme trusts	17
3.1	Introduction to section 8C	17
3.2	Important definitions	18
3.2.1	Equity instrument	18
3.2.2	Restricted equity instrument	20
3.2.3	Vesting date	21
3.2.4	Market value	22
3.3	Applying Section 8C to a Share Incentive Trust	23
3.4	Conclusion	24
4	Analysis of dividends, dividends withholding tax and relevant exemptions	26
4.1	Dividends and dividends withholding tax	26
4.2	Dividend payments from employee share scheme trusts	28
4.3	Conclusion	33
5	Employee share schemes and dividends in the United Kingdom	35
5.1	United Kingdom employee share schemes	35
5.2	Dividends and dividends tax	38
5.2.1	Previous system up to 31 March 2016	39
5.2.2	Current system effective 1 April 2016	39

5.3	Comparing the Share Incentive Trust and the Share Incentive Plan	40
5.3.1	Share Incentive Trust in South Africa	41
5.3.2	Share Incentive Plan in United Kingdom	42
5.3.3	Which one is better	43
6	Davis Committee Trust Reform Recommendations	45
6.1	Brief overview	45
6.2	Proposed changes to the taxation of trusts	46
6.3	Effect these changes will have on employee share scheme trusts	50
7	Case studies	52
7.1	Introduction	52
7.2	Case study 1 – Share incentive trust (current tax treatment)	52
7.2.1	Facts	52
7.2.2	Application of current tax law	54
7.2.3	Outcome	58
7.3	Case study 2 – Share incentive trust (hypothetical tax treatment based on Davis Tax Committee recommendations)	58
7.3.1	Facts	58
7.3.2	Application of proposed changes by the Davis Tax Committee	60
7.3.3	Outcome	62
7.4	Conclusion	63
8	Conclusion, recommendations and areas of future analysis	64
8.1	Summary	64
8.2	Recommendations	65
8.3	Areas of future analysis	66
9	Bibliography	67

1 Introduction

1.1 Title of this dissertation

Dividend payments from Employee Share Scheme Trusts.

1.2 Background and purpose of this study

In recent years, the treatment of dividends paid out from employee share schemes trusts has been one of the focus areas for National Treasury. As a result, there have been regular amendments to section 10(1)(k) and section 8C of the Income Tax Act No. 58 of 1962 (ITA). The former section deals with dividends and the latter section focuses on the taxation of directors and employees on vesting of equity instruments.

Employee share schemes are common practice as they are tools to align employees and shareholders, improve productivity and the prospect of retaining staff. Dividends received from shares held in these schemes are usually exempt from normal tax but exceptions do exist. The proposed amendments in the draft Taxation Laws Amendment Bill (TLAB) of 2013 were to tax dividends received from restricted equity instruments as income in the hands of the employee and in line with this not to be subject to Dividends Withholding Tax (DWT). These proposed changes were scheduled to be effective from 1 March 2014, and would have affected all existing schemes (Ger, 2013).

These draft proposals were abandoned in the final Taxation Laws Amendment Act (TLAA) of 2013 as it was found that it would have a negative impact on the majority of participants in these schemes, who are low-income employees. The current legislation, introduced with effect from 26 October 2014, states that dividends received in respect of services rendered or by virtue of employment will be subject to income tax, except for dividends in respect of a section 8C 'restricted equity instrument' and dividends in respect of equity shares held. This effectively means that dividends relating to unrestricted equity instruments held by virtue of employment/services rendered are not exempt, and will also be subject to income tax. If the dividends do not relate to a share as prescribed in section

8C, it will be taxed as normal income in the hands of the employee. This also triggers the responsibility of the employer to deduct Pay As You Earn (PAYE) from the distribution. Section 10(1)(k)(i)(ii) of the ITA was also introduced to address the situation where employers are disguising salaries and bonuses as dividend payments to members of share scheme trusts (Spamer and Treurnicht, 2013). The intention behind this new section, introduced in the final TLAA of 2013, is quite clear but it is not entirely certain whether it is having the desired effect as there is still uncertainty around the treatment of dividends from unrestricted equity instruments.

There is uncertainty regarding the interpretation of parts of section 8C. An analysis will thus have to be undertaken to understand the meaning of certain definitions within the section. These interpretations of the Act could have a significant impact on the tax treatment of employee share scheme trusts¹, be it DWT or normal income tax as per section 8C.

The trust tax recommendations by the Davis Tax Committee (DTC) in its first Report, reinforced in the Finance Minister's speech on the 2016 Budget, will further complicate the matter. The DTC was recommending the following amendments, inter alia, to the existing legislation:

- The flat rate of tax for trusts should be maintained
- The deeming provisions of section 7 and 25B insofar as they apply to RSA resident trust arrangements should be repealed
- Trusts should be taxed as separate taxpayers (Davis Tax Committee [DTC], 2015)

If these recommendations come into effect, it would change the way local employee share scheme trusts are taxed. The 'conduit principle' would no longer exist and exempt dividends would no longer flow through to beneficiaries of the scheme. Instead the trust would be taxed as a separate taxpayer on all its income, and distributions will be made to

¹ Only local trusts will be dealt with

beneficiaries after tax, possibly resulting in smaller amounts being distributed. Since dividends will still be exempt to the trust, would this be better or not.

This dissertation will focus on areas that will provide insight into dividend payments passed on from employee share scheme trusts to employees and the tax treatment thereof. Firstly, knowing how trusts, employee share schemes, dividends and DWT work will assist in understanding the overall structure and the reason for implementing these employee share schemes. Looking at section 8C, an analysis will be provided on the relevant definitions contained in this section. The meaning of these definitions plays a crucial role in how employee share scheme trusts are created and administered, and the interpretation of the legislation affects how they will be taxed. The first DTC report on Estate Duty, specifically pertaining to Trust recommendations, will then be considered to ascertain the possible changes in tax treatment of dividends received from employee share scheme trusts. Lastly, two case studies will be conducted to analyse the tax effects when receiving dividends as it currently stands and if the DTC recommendations were to come into effect.

1.3 Research objective

The objective of this dissertation is to determine the tax effects, focusing mainly on dividend payments, from Employee Share Scheme Trusts. The key focus areas are section 10(1)(k)(i)(dd), 10(1)(k)(i)(ii) and section 8C of the ITA. By analysing these sections and the changes to the legislation, one can gain a better understanding of the current tax treatment of dividend payments from employee share scheme trusts. The question that will then need to be answered is; is the legislation clear and precise or are there ambiguities that need to be addressed? The DTC is recommending that the taxation of trusts be amended as part of its proposed changes to the estate duty system. How will these recommendations affect the taxation of employee share scheme trusts?

1.4 Research method

A doctrinal investigation research method was used by looking at the writings of experts, interpretations of the ITA and the DTC's first interim report on Estate Duty which provides recommendations on the taxation of trusts.

A case study approach will be followed to determine the tax implications as they currently stand and then how these will change if the recommendations of the DTC are legislated.

1.5 Scope and limitations of this study

The scope of this study will be limited to the direct income tax, DWT and Capital Gains Tax (CGT) implications for employee share scheme trusts. The focus will be on domestic trusts and South African residents, therefore an analysis of foreign trusts and non-residents will be excluded from this study.

1.6 Structure of this paper

The chapters of this dissertation will deal with different aspects relating to the taxation of employee share scheme trusts.

Chapter 2 will focus on the nature and history of trusts, the conduit principle and the different types of employee share schemes utilised in the workplace.

Section 8C deals with the taxation of directors and employees on vesting of equity instruments. Chapter 3 will analyse the definitions in this section of the ITA and how it applies to employee share scheme trusts.

Chapter 4 will analyse dividends and DWT and also determine how dividend payments from employee share scheme trusts will be treated for income tax and DWT purposes. The dividend exemptions contained in section 10(1)(k) of the ITA will also be looked at and all relevant provisions relating to employee share scheme trusts and section 8C will be identified.

Chapter 5 will focus on employee share scheme trusts from a United Kingdom perspective. This will provide useful insight into the way schemes are treated in another country. Although the United Kingdom is a first world country it has similar sophisticated share schemes as in South Africa.

The DTC provided recommendations for the taxation of trusts in its first interim report on estate duty. Chapter 6 will analyse these recommendations and determine how they will affect the taxation of employee share scheme trusts.

To gain a better understanding of the overall tax consequences, Chapter 7 will look at 2 case studies to analyse the tax effects for employee share scheme trusts. The 1st case study will look at the tax treatment as it currently stands and the 2nd case study will look at the tax treatment based on the DTC recommendations.

Finally, a conclusion on the research question “Is the legislation clear and precise or are there ambiguities that need to be addressed?” is provided in Chapter 8.

2 Analysis of Trusts and Employee Share Schemes

2.1 Trusts

Trusts have always been a popular choice in South Africa to provide taxpayers with a vehicle to safeguard their assets. Over the years trusts have been the focus of various government appointed enquiries to ascertain their effect on the economy. The first major enquiry was the Margo Commission in 1987, the second being the Katz Commission in 1996 and most recently the Davis Tax Committee (DTC) appointed in 2013.

Section 1 of the Income Tax Act No. 58 of 1962 (ITA) defines a trust as follows.

Trust means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person.

There are 3 parties involved in a trust. They are (1) the donor/founder/settler, (2) the trustee(s) and (3) the beneficiary.

Donor/Founder/Settlor of a trust

The South African Revenue Service (SARS) website defines a donor/founder/settlor of a trust as follows.

Person who starts the process leading to the creation of a trust and establishes the terms of the trust. The property may be transferred to a trustee to be held in trust or may declare a trust of the property which is already held.

As the definition suggests, the donor is the person that sets up the trust and makes the initial donation. They will set up the trust for a specific purpose, be it to protect assets, facilitate a trade, administer share incentive schemes or to create a vehicle that generates income for a family once the donor has passed away. The donor can also be a trustee and/or beneficiary of the trust, but may not be the only trustee and beneficiary.

Trustee

Section 1 of the ITA defines a trustee as follows.

Trustee, in addition to every person appointed or constituted as such by act of parties, by will, by order or declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interest or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability.

The trustees are the people appointed to oversee and make decisions regarding the assets in the trust. They do not have to have any connection or interest in the assets. The donor, beneficiary and related parties can be trustees but for the sake of independence it is often advisable to have at least one independent trustee. (PW Harvey & Co, n.d.)

Beneficiary

Section 1 of the ITA defines a beneficiary as follows.

Beneficiary in relation to a trust means a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust.

The beneficiaries can be individuals or other entities who benefit from the assets and the income generated from these assets. Depending on the type of trust, beneficiaries will have different rights to the income in the trust.

Some of the advantages and disadvantages of a trust are:

Advantages:

- A trust is an excellent tool to save on tax as all the income and capital gains can be distributed to the beneficiaries. If the beneficiaries are under the maximum marginal tax rate of 41 per cent, there will definitely be a tax saving;

- Trusts are used to protect assets which then cannot be attached by creditors if you go insolvent;
- To hold shares until awarded as part of share incentive scheme;
- Family trusts are established to hold assets for the benefit of all family members; and
- Trusts usually operate for a maximum of 50 years unless it is terminated by mutual agreement or the happening of an event as stipulated in the trust deed (Fouche, 2011).

Disadvantages:

- There are costs involved to administer the trust. Accounting records will have to be kept and trustees need to be paid for their duties;
- The donor forfeits the ownership of any assets transferred to the trust; and
- The trust tax rate of 41 per cent is quite high compared to corporate tax rate of 28 per cent and individual tax brackets, apart from the highest which is also 41 per cent (Fouche, 2011).

There are two types of trusts that are recognised in South African law. The bewind trust and the ownership trust.

2.1.1 Bewind trust

A bewind trust is where the donor transfers ownership of the assets to the beneficiaries and they become the actual owners of the assets in the trust. This would either be shares or part ownership in property for example. Control of the shares or property will however, be handed over to the trustees (Cliffe Dekker Hofmeyr, 2012.).

2.1.2 Ownership trust

An ownership trust is where the donor transfers ownership of the assets to the trustee who administers them in terms of the trust deed, for the benefit of the beneficiaries (Cliffe Dekker Hofmeyr, 2012.).

There are two types of ownership trusts, namely a discretionary trust and a vesting trust.

2.1.2.1 Discretionary trust

The most common form of trust is the discretionary trust. The trustees have the ability to use their discretion to vest the trust asset in all or any of the beneficiaries, be it capital or income. They can vest all the income or only a part of the income during the year of assessment. This means that the beneficiaries only have a hope or contingent right to the income or capital in the trust (Cliffe Dekker Hofmeyr, 2012.).

2.1.2.2 Vesting trust

In a vesting trust, the trustees are not able to exercise their discretion as the income or assets in the trust automatically vest to the beneficiaries. This means that the beneficiaries have a vested right to the income or capital in the trust (Cliffe Dekker Hofmeyr, 2012.).

2.2 Conduit principle

The trust is an excellent tool for distributing income to beneficiaries who may be at different tax rates. This is made possible by the trust conduit principle. When income accrues to the trust, the trustees can award the income to the beneficiaries in the same year of assessment and it will retain its nature in the hands of the beneficiary. Section 80 of the Eighth Schedule to the ITA also specifically provides for this application in terms of capital gains tax (CGT). It provides that where a capital gain arises in the trust from a disposal of a trust asset, the gain can be distributed among the beneficiaries however the trustees see fit (Vogelman and Coetzee, 2007).

Cliffe Dekker Hofmeyr (2013) notes that the conduit principle is a problem to the fiscus due to the splitting of income and deductions. Take interest income as an example: Assume that the trust earns R60 000 interest during the year and has 3 beneficiaries who are natural persons. Assuming section 7 is not applicable, if the trustees decide to retain the income, the trust will be taxed at 41 per cent and pay tax of R24 600 because there are no exemptions. If the trustees were to distribute the interest income equally, each beneficiary would receive R20 000 interest. Natural persons are each entitled to a R23 800 interest exemption in terms of section 10(1)(i) of the ITA so assuming they have no other interest they would effectively pay zero tax on the interest. As you can see the fiscus is losing out on R24 600.

National Treasury has been suggesting for many years that it wants to override this conduit principle but nothing has been done as yet. The DTC is currently looking at this conduit principle and making recommendations, it is expected that something will change in the near future. The main recommendation is that trusts be taxed on all income in the year of receipt or accrual before it is distributed or vested. The recommendations on trusts by the DTC will be discussed in greater detail in Chapter 6.

2.2.1 Section 25B

The trust conduit principle is confirmed in section 25B of the ITA.

Section 25B (1) states the following.

Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.

This section provides that where a beneficiary has a vested right to the income in trust, the income is deemed to have accrued to the beneficiary. In *Armstrong v Commissioner of Inland Revenue* it was established that trust income which is taxable in the hands of the beneficiary does not lose its identity as it passes through the trust. In terms of dividends, any dividends declared to a trust and then vested to a beneficiary in the same year will retain its nature as a dividend and accrue to the beneficiary (Vogelman and Coetzee, 2007).

2.2.2 Section 7

Section 25B is made subject to section 7 of the ITA. Section 7 contains anti-avoidance provisions which were introduced to curb taxpayers from distributing income out of the trust in order to avoid tax. Taxpayers can distribute trust income to individuals in lower tax brackets in order to avoid tax (Bechard, 2015). A typical example would be distributing income and/or capital gains to a minor child who would be taxed at a lower tax rate instead of the father who may be at the maximum marginal tax rate. Section 7 would be triggered and deem the income to be received in the hands of the father and taxed at his marginal rate (Goebel, 1999). Some other instances where section 7 would apply are briefly described below.

Section 7(2) deals with a situation where, inter alia, trust income that is distributed to a spouse is deemed to have accrued in the donor's hands.

Section 7(3) deals with a situation where, inter alia, trust income that is distributed to minor children is deemed to have been received by their parent. This is to prevent income splitting between parents and minor children.

Section 7(4) prevents the avoidance of paragraph 3 through the use of a 3rd party. Taxpayers would donate to another person's child and they would do the same hence avoiding paragraph 3. This section put a stop to that.

Section 7(5) provides that if a person makes a donation that is subject to a stipulation or condition, any distribution to a beneficiary as a result of the donation will be deemed to be income of the person and is taxable in his hands, while the condition is still in place. For example, when a trust deed stipulates that income can only be distributed once a child reaches a certain age.

Section 7(6) was introduced for the situation where a donor disposes of an asset to a trust but still retains the right to revoke the right of a beneficiary to any income from that asset. This section deems the income attached to this right to be taxable in the hands of the donor and not the beneficiary.

Section 7(7) prevents a situation where a donor would transfer his right to receive income to another person but still retain ownership of the asset. This section deems the income forfeited to accrue to the donor.

Section 7(8) requires that any income received by a non-resident by reason of a gratuitous disposition by a resident, to be included in the income of the resident.

2.3 Employee share schemes

Employee share schemes have been around for nearly 6 decades and have become a popular mechanism for companies to reward various levels of staff. Louis Kelso created one of the first schemes, called the employee stock ownership plan (ESOP), in 1956. He created this for the employees of the Peninsula Newspaper in California to buy out the newspaper chain (Narvaez, 1991).

There are various types of employee share schemes at the disposal of prospective employers looking to start up schemes. Over time, companies have altered and amended existing scheme structures to suit their needs and to obtain the most tax effective solution.

According to Edward Nathan Sonnenbergs (ENS), three types of schemes were popular between 1996 and 2004. One type, the deferred delivery scheme, became the most popular option for many of the listed companies at the time. Prior to the introduction of

section 8C in 2004, section 8A only taxed the employee when they exercised their right of acquisition. Since the introduction of section 8C, the employee is taxed when the shares become unrestricted. (Visser, 2012)

A common tool for setting up these schemes is the formation of a trust. Edward Nathan Sonnenbergs Inc. (ENS, 2008) stated the Share Incentive Trust (SIT) as being a popular vehicle to implement employee share schemes. The structure and nature of a trust makes it an excellent vehicle for holding shares on behalf of employees. The company would create a trust which in turn would buy shares in the company. The employees would then become beneficiaries of the trust and receive benefits, such as dividends and voting rights, until a specified period has elapsed. Once this period has elapsed, the employees would receive the shares for a consideration as stipulated in the scheme contract.

While there are many types of employee share schemes in existence, for the purposes of this analysis, we will only be looking at three variations of the employee share scheme. The share purchase scheme, share option scheme and the deferred delivery share scheme.

2.3.1 Types of share schemes

2.3.1.1 *Share purchase scheme*

Gad, Coetzee, Farrand, Speirs & Ellis (2010) describe the share purchase scheme as one where an offer is made to the employees to purchase shares in a company. This can either be at market value or at a discounted rate. The acquisition and/or retention of the shares may be subject to specific conditions. These conditions would normally relate to continued employment or performance related requirements. This plan is open to all employees and can be offered with different terms for each employee, as long as there is no unfair discrimination.

The share purchase scheme is the most basic form of employee share scheme. The employer may form a trust to acquire shares in the company which it will hold until the employees are able to buy the shares, usually by way of a loan from the employer. The

employee then has the right to purchase the shares that have been allocated to him. The shares are usually financed by granting a loan to the employee, which must be repaid over a prescribed period. On this acquisition date, the employee receives all voting and dividend rights, but the dividends are usually used to repay the loan until it is fully paid. Once the loan is fully paid up, the employee then has the option to sell or keep the shares and continue earning dividends (Gad, Coetzee, Farrand, Speirs & Ellis, 2010).

2.3.1.2 *Share option scheme*

The share option scheme is very similar to that of the share purchase scheme. ENS (2008) mentions that the share option scheme is a relatively easy scheme to implement due to it being uncomplicated and the costs are minimal. The only documentation required is the terms of the share option scheme and an option agreement between the company and employee.

The employer will offer options to employees to purchase shares who will have to accept within a certain period. This gives them the right to a fixed number of shares at a predetermined price at a fixed date in the future. This price is normally called the option price and is determined by looking at the fair market price on the date the option is put forward to the employee. The employer may offer the shares at a lower price than the fair market price, this means that the option price is often referred to as the price determined by the employer (Hoek, D. and Robb, N. 2012; Jonas, 2012).

There is a fixed period in which the employee is able to exercise the option granted to him. There is no obligation for the employee to accept this offer but it must be accepted within the allowable time stipulated in the contract. Once accepted, the employee is required to pay the full amount. The employee will only enjoy full ownership and the right to vote and receive dividends once full payment is made (Jonas, 2012).

2.3.1.3 *Deferred delivery share scheme*

The deferred delivery share scheme is where selected employees are given the option to buy shares from day 1. Be it from a share trust or directly through the employer, the employees will have the option to exercise at the day 1 price (i.e. ownership passes) but delivery only occurs at a later date.

The tax implications are triggered when the options are exercised therefore the tax is calculated on the market value of the shares at day 1. The employee would then only receive the shares at a future date where the market value could be significantly higher. The benefit of this scheme was receiving the shares at a higher value and only paying tax on the market value at exercise date.

2.3.2 Share incentive trust

Share incentive trusts (SITs) have always been considered to be a great tool for companies to hold shares on the employer or employee's behalf. Since the inception of section 8C however, it has been slowly losing its popularity. A typical SIT would involve the employer company forming the trust which then subscribes for all or part of the shares in the company. Employees of the company would then be appointed as the beneficiaries of the trust and receive all the benefits from these shares until a specified future date. Once the future date has been reached the beneficiaries would receive the shares. Depending on the trust deed, these would be acquired by the employees at either the market value, less than market value or for free (ENS, 2008).

Generally a SIT formed for the majority of employees will be subject to the provisions of section 8B and not section 8C of the ITA. As this is not the focus of this dissertation, the effects of section 8B will be ignored. Emphasis will rather be placed on a SIT which is only open to certain employees and not a broad-based plan. These types of SITs are then subject to the provisions of section 8C which will be analysed in greater detail in Chapter 3.

The type of scheme that will be analysed going forward is where the employer has the right to decide which employees are allocated with participation rights. The extent of these participation rights are not detailed in the trust deed and the company usually has the right to oversee this whole process. The employee will have a right to a certain number of shares and any income from these shares. They may be required to buy the shares at a price determined by the company, but this may only happen at the end of a specified lock-in period (ENS, 2008).

The employee becomes a beneficiary of the SIT as soon as he receives the participation rights. An important thing to note is that the employee does not receive a vested right to shares as they will only vest after the expiry of the specified lock-in period. The employee can then either sell the shares or transfer them into his own name only if he has paid the full purchase price, any balance will have to be settled (ENS, 2008).

The beneficiaries may have a vested right to the dividends paid from the shares during the lock-in period. If the initial purchase price of the shares was not paid then these dividend payouts will usually be set off against the balance outstanding on these shares. The provisions of section 8C will apply because the employee received the right to shares in the company he works for. The basis for section 8C is that employees will be taxed on the difference between the price paid for the share in the SIT and the market value on the date they become unrestricted, in other words when the lock in period has expired. This is referred to as the vesting date (ENS, 2008).

An example of how section 8C applies to a SIT will be analysed in Chapter 3, but first an analysis on how section 8C works will be conducted.

3 Implications of section 8C on employee share scheme trusts

3.1 Introduction to section 8C

Prior to 26 October 2004, there was only section 8A in the Income Tax Act No. 58 of 1962 (ITA). Section 8A applied to any share options before this date. It states that there shall be included in a director or employee's income the amount of any gain made by the exercise, cession or release of any right to acquire any marketable security (Muller, 2009).

After 26 October 2004, a new section 8B was introduced to specifically deal with amounts derived from broad-based employee share plans. The reason for this was to provide some tax relief for employees who received shares through these schemes (Muller, 2009).

Section 8C was also introduced on 26 October 2004 to effectively tax gains and losses on equity instruments acquired by virtue of employment or directorship. In most cases the gain would be taxable under the gross income definition and the provisions of the Seventh Schedule which deals with benefits received as a result of being an employee, however paragraph 2(a) of the Seventh Schedule specifically excludes equity instruments acquired under Section 8C (Muller, 2009).

Section 8C focuses mainly on three areas; vesting, equity instruments and restricted equity instruments. The emphasis is placed on when the equity instrument vests in the employee. Any gain or loss arising on the vesting date will be included in the employee's income in accordance with Section 8C (Jonas, 2012).

Section 8C (1) (a) states the following.

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

- i) *by virtue of his or her employment or office of director of any company or from any person by arrangement with the taxpayer's employer;*
- ii) *by virtue of any restricted equity instrument held by that taxpayer in respect of which this section will apply upon vesting thereof; or*
- iii) *as a restricted equity instrument during the period of his or her employment by or office of director of company from –*
 - (a) *that company or any associated institution in relation to that company; or*
 - (b) *any person employed by or that is a director of –*
 - A. *that company; or*
 - B. *any associated institution in relation to that company.*

The definitions contained in section 8C play a big part in determining the tax treatment of dividends from employee share schemes. Some of the more important definitions are presented in the next section.

3.2 Important definitions

3.2.1 Equity instrument

The term 'equity instrument' was introduced by section 8C. Section 8C(7) defines it as follows.

A share or a member's interest in a company, and includes –

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

The word financial instrument is defined in section 1 of the ITA and includes the following, ‘...any other contractual right or obligation the value of which is determined directly or indirectly with reference to a debt security or equity, any commodity as quoted on an exchange or a rate index or a specified index...’.

The definition of an equity instrument can be very wide. The problem is taxpayers will always come up with new employee share schemes to circumvent section 8C and not pay income tax on the gain on vesting date (National Treasury, 2013).

An amendment was made to the definition of equity instrument on 21 October 2008 to include paragraph (c) where it states ‘any contractual right or obligation the value of which is determined directly or indirectly with reference to a share or member’s interest’. This was included so that employees who only had a contractual right to the appreciation in value of a share and not the share itself, would also fall under the provisions of section 8C (Muller, 2009).

Another key aspect to the equity instrument definition when it comes to dividends is the wording ‘or part of a share’. Does the entitlement to dividends only, and not the underlying share, fall into this definition?

There has been some doubt regarding Paragraph (c) of the definition as it does not include the words ‘part of a share’, it only states share. The omission of these words points towards the possible exclusion of dividend rights as an equity instrument. If this were the case, the entitlement to dividends only would mean it falls out of the definition in section 8C and therefore exempt from normal tax (KPMG, 2014).

Advocate Seligson however, believes the most likely interpretation is what was previously included under ‘part of shares’ in paragraph (a); the fact that the contractual right is linked to the value of a share and it can be directly or indirectly linked. With regards to the right to dividends, the value of the right is measurable and can be linked to the value of the share, whereas the right to vote has no monetary value. The value of the right must be determined directly or indirectly with reference to a share. It is evident that

the amendments are attempting to expand on the definition rather than contracting it (KPMG, 2014).

3.2.2 Restricted equity instrument

In order to determine whether an equity instrument has vested, one has to determine whether it is unrestricted or restricted.

Section 8C(7) defines a restricted equity instrument as follows.

Restricted equity instrument in relation to a taxpayer means an equity instrument -

- (a) which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;*
- (b) which is subject to any restriction that could result in the taxpayer –*
 - i) forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or*
 - ii) being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;*
- (c) if any person has retained the right to impose a restriction contemplated in paragraph (a) or (b) on the disposal of that equity instrument;*
- (d) which is an option contemplated in paragraph (a) of the definition of ‘equity instrument’ and where the equity instrument which can be acquired in terms of that option will be a restricted equity instrument;*
- (e) which is a financial instrument contemplated in paragraph (b) of the definition of ‘equity instrument’ and where the equity instrument to which that financial instrument can be converted will be a restricted equity instrument;*
- (f) if the employer, associated institution in relation to the employer or other person by arrangement with the employer has at the time of acquisition by the taxpayer of the equity instrument undertaken to-*

- i) cancel the transaction under which that taxpayer acquired the equity instrument; or*
- ii) repurchase that equity instrument from that taxpayer at a price exceeding its market value on the date of repurchase, if there is a decline in the value of the equity instrument after that acquisition; or*
- (g) which is not deliverable to the taxpayer until the happening of an event, whether fixed or contingent.*

It became necessary for National Treasury to differentiate between an unrestricted and restricted equity instrument due to the ever-evolving nature of employee share schemes.

Employers used these employee share schemes to align the interest and objectives of the company with that of the employees. Restrictions were placed on these equity instruments in order to retain the employees. The South African Revenue Service (SARS) noticed this trend, hence the inclusion of the restricted equity instrument definition (Jonas, 2012).

The inclusion of the restricted equity instrument definition was important as it built on the underlying principle of section 8C being the taxable event, also called the vesting date. Interpretation Note 55 (IN55) provides valuable guidance on this and many other aspects.

3.2.3 Vesting date

One of the major differences between section 8A and section 8C is the concept of vesting. Once a restricted equity instrument has vested, a gain or loss is realised in the hands of the employee.

According to section 8C(3)(b), the vesting date of a restricted equity instrument is at the earliest of -

- i) when all the restrictions, which result in that equity instrument being a restricted equity instrument, cease to have effect;*

- ii) *immediately before that taxpayer disposes of that restricted equity instrument, other than a disposal contemplated in subsection (4) or (5)(a), (b) or (c);*
- iii) *immediately after that equity instrument, which is an option contemplated in paragraph (a) of the definition of ‘equity instrument’ or a financial instrument contemplated in paragraph (b) of that definition, terminates (otherwise than by the exercise or conversion of that equity instrument);*
- iv) *immediately before that taxpayer dies, if all the restrictions relating to that equity instrument are or may be lifted on or after death; and*
- v) *the time a disposal contemplated in subsection (2)(a)(i) or (b)(i) occurs.*

Vesting does not mean that the share was disposed of or the option exercised, but rather that the employee is in the position to dispose of or exercise. This means that vesting can occur without any action on the part of the employee (Muller, 2009).

The vesting date becomes particularly important when it comes to the taxation of dividends. In Chapter 4 we will look at section 10(1)(k)(i)(dd) of the ITA where it states that a dividend will not be exempt from normal tax when received in respect of a restricted equity instrument unless certain exceptions apply. Determining if an equity instrument is restricted or unrestricted is crucial in terms of applying section 10(1)(k)(i)(dd) and also 10(1)(k)(i)(ii) when a dividend is declared and paid. When the vesting occurs, the employer company is responsible for deducting the necessary PAYE in terms of para 11A of the Fourth Schedule of the ITA if there is an actual gain.

3.2.4 Market value

The term ‘market value’ in relation to section 8C has its own definition. In section 8C(7) it states.

Market value, in relation to an equity instrument –

- (a) of a private company as defined in the Companies Act or a company that would be regarded as a private company if it were incorporated*

under that Act, means an amount determined as its value in terms of a method of valuation-

- i) prescribed in the rules relating to the acquisition and disposal of that equity instrument;*
- ii) which is regarded as a proxy for the market value of that equity instrument for the purposes of those rules; and*
- iii) used consistently to determine both the consideration for the acquisition of that equity instrument and the price of the equity instrument repurchased from the taxpayer after it has vested in that taxpayer; or*

(b) of any other company, means the price which could be obtained upon the sale of that equity instrument between a willing buyer and a willing seller dealing freely at arm's length in an open market and, in the case of a restricted equity instrument, had the restriction to which that equity instrument is subject not existed.

In simpler terms there are 2 definitions of market value for the purposes of section 8C, one for private companies and one for all other companies. Because of the structure of a private company, it is not always possible to determine the fair value of its equity instruments. That is why alternative methods are provided to determine the market value. One of these methods is through the use of a formula which if used consistently to calculate the amount payable by the employee for the equity instrument, can become an acceptable means of calculating the market value. For any other type of company it is much easier and follows the usual methodology of an arm's length transaction in an open market between a willing buyer and willing seller (Jonas, 2012).

3.3 Applying Section 8C to a Share Incentive Trust

A brief example of how the provisions of section 8C apply to a Share Incentive Trust (SIT) would be beneficial at this stage. In general, the date that the gain or loss is included as taxable income depends on whether the share is a restricted or unrestricted equity instrument.

John Black (John) is upper management at company XYZ (Pty) Ltd. XYZ (Pty) Ltd forms a share incentive trust, ABC Trust, for the benefit of certain employees. John is given participation rights to 1 000 shares in XYZ (Pty) Ltd. The trust deed stipulates that he has a vested right to the dividends received by the trust from the 1 000 shares that are his. The shares will only vest after a lock-in period of 3 years. This is therefore a restriction as mentioned in the restricted equity instrument definition. Only once this restriction is lifted will the shares vest (ENS, 2008).

John does not pay anything for the participation rights but as he has a vested right after 3 years, he will have to pay R20 per share. When the shares vest in 3 years' time, the market value of the shares is actually R30 per share. At the 3 year mark there are no longer any restrictions and the shares vest in John (ENS, 2008).

As discussed above in terms of section 8C, John will be taxed on the difference between the price he paid for the shares (R20) and the market value at vesting date (R30). The gain of R10 per share times 1 000 shares (R10 000) will be subject to income tax in the form of PAYE and will be deducted as such (ENS, 2008).

A more detailed example of a SIT taking into account all transactions and tax effects, especially dividends, will be analysed in Chapter 7.

3.4 Conclusion

There are two key factors which can be taken from the analysis of section 8C in connection with dividends. Firstly, whether dividend rights also fall within the definition of equity instrument and are also classed as an equity instrument under section 8C. Secondly, the importance of vesting dates in relation to dividend payments from restricted and unrestricted equity instruments, as the legislation is quite ambiguous in this regard.

National Treasury has taken note of the intention to disguise salaries as dividend payments and attempted to rectify this in the TLAA of 2013 (National Treasury, 2013). The Explanatory Memorandum to the 2013 TLAA notes that internationally, revenue

authorities are attempting to strengthen policies to curb the use of dividends as disguised salaries. In South Africa, the anti-avoidance rules with regards to this conversion are too narrow as they only target dividends from non-equity shares. Certain share schemes operate by solely holding equity shares to generate dividends as compensation for employees. This is done without ever transferring ownership to the employees. The dividends in this scenario are effectively disguised salaries.

The proposed solution to this problem is to tax dividends paid to employees for services rendered in respect of or by virtue of employment or holding of an office as normal income and therefore not subject to dividends tax. This anti-avoidance measure was to target these specific schemes, so in order for the changes in legislation to not affect genuine share schemes, the measure will not apply to dividends paid in respect of restricted equity instruments or shares held directly by the employee (National Treasury, 2013).

These changes seem to indicate that only dividends paid in relation to unrestricted equity instruments received by virtue of employment will be taxed as normal income. There is still confusion as the legislation is not very clear. If a section 8C restricted equity instrument is not subject to normal tax on vesting, after this date it becomes an unrestricted equity instrument and the employee will be subject to tax on all future dividends.

Chapter 4 will focus on dividends and the relevant exemptions in section 10 of the ITA, in relation to section 8C, to get a better understanding of dividends payments from employee share scheme trusts.

4 Analysis of dividends, dividends withholding tax and relevant exemptions

4.1 Dividends and dividends withholding tax

By examining dividends and dividends withholding tax (DWT), we can gain a better understanding of the taxation of dividends paid to employees from employee share scheme trusts.

According to section 1 of the Income Tax Act No. 58 of 1962 (ITA), dividend means:

any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied –

(a) by way of a distribution made by; or

(b) as consideration for the acquisition of any share in,

that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied –

i) results in a reduction of contributed tax capital of the company;

ii) constitutes shares in the company; or

iii) constitutes an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements.

For the purposes of this dissertation it would be prudent to also look at the definition contained in section 64D of the ITA. It says:

any dividend or foreign dividend as defined in section 1 that is –

(a) paid by a company that is a resident; or

- (b) paid by a foreign company –*
- i) if the share in respect of which that foreign dividend is paid is a listed share; and*
 - ii) to the extent that that foreign dividend does not consist of a distribution of an asset in specie.*

From 1 April 2012, DWT was introduced at a rate of 15 per cent, which replaced the old Secondary Tax on Companies (STC) that taxed dividends distributions by a company at 10 per cent. DWT was introduced to bring the economy more in line with international standards. The old STC system sought to tax the dividend in the hands of the company issuing the dividend, whereas the new DWT system seeks to tax the recipient in the form of a withholding tax (Jorge, 2013).

One of the main reasons for the change was that STC was not recognised internationally as a tax on the resident of another country for DTA purposes. This meant that a South African company that paid a dividend to a non-resident would not be able to make use of any DTA to reduce the rate of STC on a dividend paid to a resident of a foreign country that has a DTA with South Africa (SAICA, 2012).

Prior to the implementation of DWT, local dividends were completely exempt from tax in the recipient's hands. They are now still exempt from normal tax, but subject to a withholding tax. The rate will generally be 15 per cent, but in some instances, the dividends will be completely exempt and others it will be at a reduced rate (Haupt, 2014).

Examples of complete exemption include:

- dividend payments to withholding agents as defined in section 64D of the ITA
- dividend payments to group companies as defined in section 41 of the ITA
- dividend payments to any other South African company

The reduced rate of DWT applies to foreign residents where there is a relevant DTA with South Africa. There are other requirements attached to this reduction, but it does not fall within the scope of this discussion.

Local dividends received and accrued to a South African resident are generally exempt from normal tax in terms of section 10(1)(k) of the ITA. There is an exception to the rule, and that is dividends received from employee share schemes (Spamer and Treurnicht, 2013).

This exception will be discussed in greater detail in the next subsection.

4.2 Dividend payments from employee share scheme trusts

Section 10(1)(k)(i)(dd) of the ITA was introduced from 1 January 2011. It states that:

*There shall be exempt from normal tax - dividends (other than dividends paid or declared by a headquarter company) received by or accrued to any person:
Provided that this exemption shall not apply –*

(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 requirement contemplated in that definition;*
- B. the dividend constitutes an equity instrument as defined in that section;
or*
- C. the restricted equity instrument constitutes an interest in a trust and, where that trust holds shares, all of those shares constitute equity shares, other than equity shares that would have constituted hybrid equity instruments as defined in section 8E(1) but for the three-year period requirement contemplated in that definition.*

The introduction of this section in the ITA shows the intention to tax dividends from employee share scheme trusts as normal income in the hands of the employee. Only if one of the three above-mentioned exclusions apply, will the dividend from employee share scheme trusts be exempt from normal tax.

Spamer and Treurnicht (2013) set out four steps to follow when determining the tax treatment of dividends from an employee share scheme.

1. Determine whether the employee holds an 'equity instrument'.

This is clearly defined in section 8C. It means a share in a company, including:

- "An option to acquire such a share or part of a share"
- "Any financial instrument that is convertible to a share"
- "Any contractual right or obligation, the value of which is determined directly or indirectly with reference to a share" (Spamer and Treurnicht, 2013).

2. Was the 'equity instrument' acquired by virtue of employment?

You must be able to determine whether there is a direct link between the employment of the employee and the acquisition of the equity instrument. A mere relationship between the two is not sufficient, the employment must be the direct cause in acquiring the equity instrument (Spamer and Treurnicht, 2013).

3. Determine whether the 'equity instrument' is restricted.

A restricted equity instrument will only vest in a taxpayer when all the restrictions attached to the equity instrument are lifted or when the taxpayer decides to dispose of the equity instrument (Spamer and Treurnicht, 2013).

4. The final step is to ascertain whether one of the three exceptions in section 10(1)(k)(i)(dd) applies. If one of them does apply, then the dividend on the restricted equity instrument will be exempt from normal tax (Spamer and Treurnicht, 2013).

- 4.1. The restricted equity instrument must constitute an 'equity share' other than would have constituted a 'hybrid equity instrument' as defined in section 8E of the ITA but for the three year period requirement.

'Equity share' is defined in the ITA as a share which means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution. By using the words "neither as respects dividends nor respects capital" it is implied that both the right to the capital and the right to dividends should be restricted for the share to cease being an equity share. If one right were to be restricted and the other unrestricted, the share will constitute an equity share. Only if both the dividends and capital are restricted will it not be an equity share.

The equity share must also not constitute a hybrid equity instrument but for the three year period requirement. It will constitute a hybrid equity instrument if:

- The share does not rank equally with regards to its participation in local or foreign dividends with all the other share classes of the company or, there are two or more classes of ordinary shares in the company; or
- A local or foreign dividend on the share is calculated directly or indirectly by a specified rate of interest or the time value of money; and
- "any of the three following requirements are met:
 - 1) the issuer of that share is obliged to redeem that share in whole or in part;
 - 2) that share may at the option of the holder be redeemed in whole or in part;or
 - 3) at any time on the date of issue of that share, the existence of the company issuing that share is likely to be terminated upon a reasonable consideration of all the facts at the time." (Spamer and Treurnicht, 2013).

4.2. The dividend must constitute an equity instrument.

4.3. The restricted equity instrument must constitute an interest in a trust, when that trust holds shares, they must all be equity shares, other than would have constituted a 'hybrid equity instrument' as defined in section 8E of the ITA but for the three year period requirement (Spamer and Treurnicht, 2013).

The same reasoning as in 4.1 would also apply.

This section will now be applied to the short example already provided in Chapter 3.3. ABC Trust acquires shares in XYZ (Pty) Ltd. The beneficiaries of the ABC Trust, who are employees of XYZ (Pty) Ltd, receive vested rights to the dividends received on the shares by virtue of their employment.

- These vested rights of the employees are therefore equity instruments as per paragraph (c) of the definition of equity instrument in section 8C of the ITA. If these rights are unrestricted then there is no problem and the dividends will be exempt from normal tax. If the rights are restricted, then the 3rd subtest, as noted in 4.3 above, will have to be met for the dividends to be exempt from normal tax.
- The shares held by the ABC Trust will also be equity instruments as per section 8C(5)(b). The tax consequences of the dividends received on these shares all depend on whether the shares are unrestricted or restricted. If we assume they are restricted, then they will be subject to income tax unless they are equity shares as explained in the 1st subtest as noted in 4.1 above (Spamer and Treurnicht, 2013).

As you can see there is room for interpretation. If you can argue that the shares held by the trust are not actually equity shares as defined, then one can escape paying normal tax as the dividends will be exempt.

The initial draft of the Taxation Laws Amendment Bill (TLAB) of 2013 proposed to delete this section entirely. It sought to tax the dividends from equity instruments as normal income, unless the shares had already vested, therefore only applying to restricted equity instruments. The final TLAA of 2013 did not remove this section but rather introduced a new section 10(1)(k)(i)(ii) (Spamer and Treurnicht, 2013).

Spamer and Treurnicht (2013) mentions that the anti-avoidance provisions in place at the time were not sufficient to cover the scenario where salaries were being converted into dividends. There were schemes in place where the only aim was to generate dividends as

compensation for employees for services rendered without the employee ever taking ownership of the shares. SARS considered these dividend payments to be ‘disguised salaries’ for services rendered by employees. To address this issue, SARS introduced section 10(1)(k)(i)(ii), to try and stop this from happening. The new section became effective from 1 March 2014.

According to section 10(1)(k)(i)(ii) of the ITA:

*there shall be exempt from normal tax - dividends (other than dividends paid or declared by a headquarter company) received by or accrued to any person:
Provided that this exemption shall not apply –*

(ii) to any dividend received by or accrued to a person in respect of services rendered or to be rendered 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.

Spamer and Treurnicht (2013) also set out two tests which analyses the new section 10(1)(k)(i)(ii).

1. The first test talks about the terms ‘in respect of services rendered’ and ‘by virtue of employment’. Both are similar in the fact that they both relate to a direct relationship between being an employee of the company and the declaring of the dividend. The requirement here suggests that the dividends be received as compensation for services rendered, and are therefore a disguised salary (Spamer and Treurnicht, 2013).
2. The second test deals with the wording ‘other than a dividend in respect of a restricted equity instrument’. This means that the dividend will only be taxed if it is received from an unrestricted equity instrument (Spamer and Treurnicht, 2013).

The explanatory memorandum to the TLAA of 2013 mentions the intention is to tax dividends paid for services rendered in respect of or by virtue of employment as normal income. However, to ensure that this new legislation does not affect bona fide

share schemes, it does not apply to shares held directly by employees and restricted equity instruments.

One can see that the intention is to tax those schemes where the participants have no entitlement to the shares but are rather in place to provide dividends as a disguised salary (Spamer and Treurnicht, 2013).

Gad and McCormack (2013) also have the same view with regards to the new section 10(1)(k)(i)(ii). They mention that the dividend exemption could be at risk when receiving dividends linked to shares held in a trust. Only if the dividends received are not linked to services rendered or by virtue of employment, will the exemption be applicable and exempt from normal tax.

4.3 Conclusion

Based on Spamer, Treurnicht's, Gad and McCormack's comments, it is apparent that there is consensus on the treatment of these dividends, despite there being a lack of case law. Any share that is directly held or is a restricted equity instrument will be exempt from normal tax, as per section 10(1)(k)(i)(ii). Therefore, a dividend received from an unrestricted equity instrument not directly held that can be linked directly or indirectly to services rendered or by virtue of employment will be seen as a disguised salary and will be taxed as normal income.

One must remember that, even if an exemption from normal tax applies in terms of section 10(1)(k), the dividend will then be subject to dividend withholding tax at 15 per cent in terms of 64E.

If an exemption in terms of section 10(1)(k) does not apply and a dividend is subject to normal tax, it cannot be subject to dividend withholding tax as well. Section 64F(1)(l) of the ITA states that 'any dividend is exempt from the dividends tax to the extent that it does not consist of a dividend *in specie* if the beneficial owner is any person to the extent that the dividend constitutes income of that person'.

Additional concerns, are the recommendations on the taxation of trusts by the Davis Tax Committee (DTC). The DTC is looking at ways to reduce the effects of the trust conduit principle as the government believes taxpayers are using trusts to avoid tax and therefore damaging the fiscus. If these recommendations are accepted, no one knows how they will affect the treatment of dividends received from SIT's. If the conduit principle no longer exists, dividends paid out to these trusts from the trading companies could possibly lose their identity in the trust if they are to be taxed in the trust before being distributed to beneficiaries. The dividend exemptions mentioned above would then not apply to the employees and they could possibly just receive an income distribution from the trust and would be taxed as normal income at their marginal tax rate. One would also need to consider if any deduction would be available to the trust or individual as taxing the dividend at every step would be prejudicing the beneficiary.

These recommendations will be explored in greater detail in Chapter 6 and a detailed case study will be conducted in Chapter 7 to ascertain the possible tax effects.

5 Employee share schemes and dividends in the United Kingdom

5.1 United Kingdom employee share schemes

It would be useful to investigate how employee share schemes are used in another country and how dividends from these schemes are taxed. The United Kingdom (UK) has a wide variety of share schemes available and it would be beneficial to have a look at a few. This paper focuses more on Section 8C employee share schemes and not Section 8B broad-based employee share plans, therefore it is prudent to look at a first world country which has similar sophisticated share schemes as South Africa.

In the UK, the gifting of shares at less than market value will constitute taxable remuneration in the hands of the employee. This amount would be calculated by taking the difference between the price paid for the shares and the market value of the company's shares. It will then be subject to Pay As You Earn (PAYE) if the shares are able to be traded. This could place the employee in a vulnerable position as he will need to pay tax on these shares and may not have the cash to settle this tax (Boyd and O'Donnell, 2013), the same is applicable to South Africa.

A more tax efficient way was devised to transfer shares to employees and that is the share scheme. There are four main types of share scheme in the UK:

- Unapproved share option scheme;
- Approved share option scheme (CSOP);
- Enterprise management incentives (EMI); and
- Share incentive plans (SIP) (Boyd and O'Donnell, 2013).

Unapproved share option schemes

Employees are given options to acquire shares at a future date at any price specified by the company. Unapproved schemes do not require HM Revenue & Customs (HMRC)

approval. There are also no rules in selection of the individuals that qualify (Boyd and O'Donnell, 2013).

There will be no tax or national insurance charge when the option is granted, as long as the option is exercised within 10 years. When the option is exercised there will be income tax payable on the difference between the price paid and the market value of the shares at the exercise date (Boyd and O'Donnell, 2013).

When the shares are sold, there will be a capital gain by calculating the difference between the market value when the shares were exercised and the proceeds on date of sale (Boyd and O'Donnell, 2013).

This is very similar to the way that share schemes are taxed in South Africa. As discussed in Chapter 3, section 8C of the ITA determines the vesting date and on this date the difference between the market value and option price will be subject to income tax. When the shares are sold, the difference between the sale price and the market value at date of vesting will be a capital gain.

Approved share option scheme (CSOP)

These share schemes require HMRC approval and therefore need to meet certain guidelines. They are typically used for family businesses as only certain employees need to be included as part of the scheme. Options are given to purchase shares in the company at a later date. The price will be fixed at the market value of the shares at the date the options are granted. The options can be exercised anywhere between three and ten years (Boyd and O'Donnell, 2013).

The guidelines to qualify for a CSOP is that a person works for at least 25 hours per week and must not own more than 25 per cent of the business. The only difference between an approved and unapproved scheme is that there are no tax implications for the employee when the options are exercised in a CSOP, the tax is deferred until disposal of the shares

and the employee needs to have the cash available to pay the tax (Boyd and O'Donnell, 2013).

Enterprise Management Incentives (EMI)

These are intended for smaller start-up companies with growth potential. The aim is to retain highly skilled employees by rewarding them for taking a risk helping a start-up company grow. The scheme is only for companies not owned by another company and their asset value cannot exceed 30 million pounds (Boyd and O'Donnell, 2013).

Any number of employees can be given options to buy shares at market value or less than market value at the date the options are granted. There are certain limitations on the overall value each employee can exercise and also voting restrictions in order to protect the owner's position in the company (Boyd and O'Donnell, 2013).

HMRC must be notified within 3 months of the options being granted as well as the market value of the shares. Formal approval for this scheme is not required. The guidelines to qualify for an EMI are that an employee works for at least 25 hours per week, if less than 25 hours, at least 75 per cent of their available working hours. The employee also cannot own more than 30 per cent of the business (Boyd and O'Donnell, 2013).

There is no tax payable on either the granting of the share options or the exercise of the options, unless the options were granted at less than market value. In this case the difference at exercise date will be subject to income tax. When the shares are eventually sold, the employee is entitled to entrepreneur's relief on the capital gain, as long as the employee has owned 5 per cent of the business for at least a year (Boyd and O'Donnell, 2013).

Share Incentive Plan (SIP)

Share incentive plans are the most common schemes as they are designed to include all employees and can reward these employees for their performance. All the shares acquired under the scheme will be held in a UK resident trust (Boyd and O'Donnell, 2013).

Employees can get shares to a maximum of 3 000 pounds and will be tax free. These are generally called 'free shares'. They can buy an additional 1 500 pounds of shares from their pre-tax earnings. These are called 'partnership shares'. Employers are then allowed to match the partnership shares bought by employees on a 2 to 1 basis. That means the employer can buy a maximum of 3 000 pounds. These are called 'matching shares'. Dividends received during the year will also be tax free up to 1 500 pounds. When an employee leaves the company, they may lose their free shares if it is within 3 years (Boyd and O'Donnell, 2013).

This plan must be offered to all employees in the company, full time and part time employees. A minimum period of employment can be implemented but cannot be more than 18 months (Boyd and O'Donnell, 2013).

If the shares are kept in the plan for 5 years, there will be no income tax on the shares and no capital gains tax when sold. Shares taken out of the plan after 3 years will be subject to income tax on the initial value of the shares. Any growth while part of the plan will still be exempt from income tax. If the shares are sold while still part of the plan there will be no capital gains tax. If taken out of the plan, the capital gains tax will only be on the increase in value from the date the shares were taken out (Boyd and O'Donnell, 2013).

5.2 Dividends and dividends tax

Dividends are treated quite differently in the UK compared to South Africa. In South Africa, a dividend withholding tax is used, whereas in the UK, there is no specific dividends tax but rather normal tax on the amount of dividends exceeding a certain allowance which is dependent on a person's earnings and tax rate.

There is a new system of taxing dividends from 1 April 2016. Both systems will be looked at as comparisons to South Africa.

5.2.1 Previous system up to 31 March 2016

The previous system of taxing dividends was quite complicated. A person would be taxed on the dividend received plus a notional tax credit, this credit would then be used against the tax due on the dividends. The tax rate on dividends was 10 per cent for basic rate payers and 32.5 per cent for higher rate payers. After taking into account the tax credit, the effective rates were reduced to 0 per cent for basic rate payers and 25 per cent for higher rate payers (The Investor, 2015).

As can be seen, for the lowest tax bracket, dividends were completely tax free. Comparing this to South Africa, dividends tax is withheld at 15 per cent for individuals no matter who the recipient is and at what tax bracket they are in. The UK system is therefore far more favourable to lower and middle income earners.

For the higher rate payers it is not as favourable. Their effective tax rate on dividends would be 25 per cent, whereas in South Africa the maximum dividends payable is 15 per cent.

5.2.2 Current system effective 1 April 2016

Chancellor George Osborne announced in his Budget of 2015 that he planned on reworking the treatment of UK dividends. The old system enabled people to avoid tax by using dividends as another means of earning income rather than salaries. Salaries are subject to PAYE and if you are a basic rate payer earning dividends it would be tax free. He also mentioned that changing the dividend system allows for a further reduction in the corporate income tax rate as a result of the higher effective rates on dividends going forward (The Investor, 2015).

The new system became effective from 1 April 2016. The government removed the dividend tax credit already mentioned and instituted a tax free dividend allowance of

5 000 pounds per year of assessment. The overall effect for taxpayers with small portfolios and moderate dividends will not see much of a difference as they will be well within the 5 000 pounds allowance (Evans, 2015).

Any dividends over the annual 5 000 pounds dividend allowance will be taxed.

- 7.5 per cent for basic rate payers;
- 32.5 per cent for higher rate payers; and
- 38.1 per cent for additional rate payers.

Therefore, if a basic rate payer earns more than 5 000 pounds in dividends, they will be taxed 7.5 per cent on the additional amounts. Whereas in the previous system the dividends would be completely tax free. This will most likely curb the taxpayers who were taking the bulk of their salary package as dividends.

Comparing the new system to South Africa, dividends tax is withheld at 15 per cent for individuals no matter who the recipient is and at what tax bracket they are in. The new system in the UK is therefore still far more favourable to lower and middle income earners as the first 5 000 pounds of dividends will be completely tax free and anything over that, while still being a basic rate payer, will only be taxed at 7.5 per cent.

For the higher and additional rate payers it is definitely not as favourable. After the 5 000 pounds dividend allowance, higher rate payers will be taxed at 32.5 per cent and additional rate payers at 38.1 per cent, whereas in South Africa the maximum dividends tax payable is 15 per cent.

5.3 Comparing the Share Incentive Trust and the Share Incentive Plan

A comparison between the two employee share scheme trusts from South Africa and the UK will be beneficial and follows in the next section.

5.3.1 Share Incentive Trust in South Africa

Background

Share Incentive Trusts have always been a good tool for holding shares on behalf of employees. Often employees do not have the necessary funds to purchase the shares so they would get the shares on loan account and any dividends from these shares would be offset against the loan.

Who is eligible?

There is no formal regulation stipulated by the government on who can or can't be part of the scheme. The employer company that establishes the Share Incentive Trust will therefore stipulates who qualifies to participate, be it everyone or only certain levels of management.

Income tax and capital gains tax treatment

The Share Incentive Trust has become slightly less attractive since the introduction of section 8C because of the adverse tax consequences.

The employee will be taxed on the difference between the price of the share on exercising of the option and the market value of the share on vesting date. This will be taxed as normal income at the individual's marginal rate of tax.

Capital gains tax will only be paid when the employee eventually sells the shares. This will be calculated as the difference between the market value of the shares on date of sale and the market value of the share on date of vesting. This gain will be included at a rate of 41 per cent for individuals which results in a maximum effective tax rate of 13.66 per cent on the capital gain.

Dividends tax treatment

Any dividends distributed to the trust from the employer company will flow straight through the Trust to the employee beneficiary and retain its identity. Dividend distributions will be subject to a 15 per cent dividend withholding tax and the net amount will be non-taxable income in the hands of the employee. Therefore a total of 15 per cent tax on any dividends.

5.3.2 Share Incentive Plan in United Kingdom

Background

The Share Incentive Plan was created to allow all employees in a company to participate. Shares in the plan must be held in a UK resident trust to ensure that they are legally separate from the employer company (Boyd and O'Donnell, 2013).

Who is eligible?

A company must offer the opportunity to all employees to participate in the share plan. They can be full-time or part time employees. The only restriction that a company can impose is a minimum period of employment to qualify, this cannot exceed 18 months (Boyd and O'Donnell, 2013).

Income tax and capital gains tax treatment

There will be no income tax if the shares are kept in the plan for 5 years. No capital gains tax will be payable when the shares are sold. If the shares are taken out after 3 years in the plan, income tax will be payable on the initial value of the shares. If the shares are taken out of the plan and then sold, there will only be capital gains tax on the growth in the shares from the date they were taken out (Boyd and O'Donnell, 2013).

Dividends tax treatment

As there is no dividend withholding tax, there will be no dividends tax. Dividends paid to employees via the trust will be added to other dividend income of the employee and will be tax free up to a maximum of 5 000 pounds. Any dividends over 5 000 pounds will be taxed at the rates mentioned in section 5.2.2.

5.3.3 Which one is better

The UK scheme must be held in a resident trust whereas the SA scheme does not necessarily require a resident trust, but is the easiest option with regards to management and allocation of shares.

The South African share incentive trust can be used in a variety of ways and there is no stipulation as to who must or must not be part of the scheme, except in the case of a section 8B share plan. Participants in the scheme can be all employee or only certain employees as selected by the employer company. The UK share incentive plan has certain rules which must be adhered to in terms of participation in the scheme. All employees of the UK Company must be given the opportunity to participate, the only restriction being a minimum period of employment to join the scheme can be implemented. Depending on which way you look at it, each scheme has its own advantages. The South African share incentive trust is flexible in that it can be structured anyway the company chooses. Whereas the UK share incentive plan must be offered to all employees. This is a positive for employees as they are given the opportunity and cannot be excluded from the scheme.

Assuming that shares are kept in the respective schemes for the maximum required term, there are differences in the income tax treatment. Employees in a South African SIT would be subject to income tax as explained above in terms of section 8C whereas employees who are part of a UK SIP will not be subject to income tax. For the SIT participant, CGT will be calculated on the difference between the market price on the sale date and the market price on vesting date. The SIP participant will not be subject to CGT on the sale of the shares if the maximum term of holding the shares has been reached.

Only if the shares are taken out of the SIP will they be subject to CGT on the difference between the market value of the share on sale date and the market value on the date they were taken out of the plan. As you can see the SIP is a lot more preferable than the SIT when it comes to the income tax and capital gains tax implications. There are virtually no tax implications for employees who participate in the UK SIP, if they keep their shares within the plan.

The treatment of dividends received by participants in the two schemes is also vastly different. The dividends received by South African SIT beneficiaries will be subject to the 15 per cent dividends withholding tax, or normal tax depending on the application of section 8C. Beneficiaries of the UK SIP will not be subject to any withholding tax and according to the new system of taxing dividends, the first 5 000 pounds of dividends received in a year of assessment will be tax free. Any further dividends received over the 5 000 pound allowance will be taxed as set out in section 5.2.2. If dividends received are under the allowance then the UK SIP beats the South African SIT hands down when it comes to the tax consequences for dividends.

Based on the above analysis it would seem that the UK SIP is the better of the two employee share schemes. Although the South African SIT is more flexible in terms of eligibility, the UK SIP ensures that all employees in a company have the opportunity to participate in the scheme. The income tax and capital gains tax implications are far more favourable and the tax consequences for dividends received advantageous.

6 Davis Committee Trust Reform Recommendations

6.1 Brief overview

In the 2013/2014 budget announcement, Finance Minister Pravin Gordhan noted that the government would commence with a tax review to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability. On 17 July 2013, the Minister of Finance announced the members of the Tax Review Committee as well as their objectives. The Review Committee took on the name Davis Tax Committee, as it is led by Judge Dennis Davis (South African Revenue Service, 2013).

The DTC is tasked to look into the role the tax system has on the promotion of inclusive growth, employment, development and fiscal sustainability. It makes recommendations to the Minister of Finance who may announce these as part of the budget process. It is tasked to evaluate the tax system in South Africa against the principles and trends of other foreign countries, as well as initiatives to deal with an eroding tax base and to improve tax compliance as a whole (South African Revenue Service, 2013).

The following specific areas are being looked at:

- 1 Examine the overall tax base and tax burden.
- 2 Impact of the tax system in the promotion of small and medium size businesses. This includes analysing the cost of tax compliance and streamlining tax administration to help the sector grow.
- 3 The corporate tax system, specifically the efficiency of the corporate income tax structure, tax avoidance and possible tax incentives to promote developmental objectives.
- 4 Whether the current mining tax regime is appropriate.

- 5 Various elements of taxation in the financial sector. Long term insurers, taxation of hedge funds, VAT treatment of financial services and the VAT apportionment within the financial sector.
- 6 Possible effectiveness of dual VAT rates, zero rating and exemptions.
- 7 The impact of online delivery of goods and services on the tax base (corporate income tax and VAT).
- 8 The role and continued relevance of estate duty to support a more equitable and progressive tax system. Analyse the interaction between capital gains tax and estate duty.
- 9 Possibility of funding a National Health Insurance (NHI) and also long term infrastructure projects to boost the growth potential of the economy.
- 10 Evaluate the legislative process with a view to enhancing simplicity and ensuring the protection of the tax base (South African Revenue Service, 2013).

The DTC is required to submit interim reports and a final report will be published after consultation with the Minister of Finance.

For the purposes of this paper, the focus will be on the first interim report on estate duty published in January 2015. Chapter 4 of this interim report deals with specific recommendations for trusts which will now be analysed.

6.2 Proposed changes to the taxation of trusts

As mentioned in previous chapters, a trust is taxed at 41 per cent for income tax and an effective 32.80 per cent for capital gains tax (CGT), for the 2017 year of assessment. With the highest individual tax rate being 41 per cent, anything below the current marginal tax rate threshold of R701 301 in the 2017 year of assessment would mean the trust income

tax rate is higher. The effective CGT rate for individuals in the 2017 year of assessment is currently 16.40 per cent, therefore the trust is significantly higher.

The advantage that trusts have is that they are subject to the provisions of section 25B of the Income Tax Act No. 58 of 1962 (ITA). The trustees have the ability to vest the trust income in the hands of the beneficiaries. This is commonly referred to as the conduit principle as discussed in Chapter 2. All distributions are however subject to the deeming provisions of section 7 of the ITA.

Section 7 of the ITA was originally intended to be an anti-avoidance mechanism to prevent trusts from splitting its income to various beneficiaries. These anti-avoidance measures used to be effective in the past when trusts were taxed on a sliding scale similar to individuals. They were taxed like this prior to years of assessment commencing on or after 1 March 1998. Individual tax rates were significantly higher at the time, so by using a trust and splitting income to various sources, one could reduce the amount of tax paid. Therefore section 7 was necessary to prevent the splitting to more tax favourable parties (Davis Tax Committee, 2015:37).

At one point, 1999 to 2002, there was a dual rate of tax for trusts. Income up to R100 000 was taxed at 35 per cent and anything above was at 45 per cent, the maximum marginal rate for individuals at the time. A scheme was then developed whereby taxpayers would create a string of trusts and each would only generate R100 000 income to take advantage of the reduced rate of 35 per cent (Davis Tax Committee, 2015:37).

Since the 2003 year of assessment, trusts have been taxed at a flat rate of 40 per cent (this changed to 41 per cent in 2015) and an effective rate of 26.64 per cent for CGT (changed to 27.31 per cent in 2015 and 32.80 per cent in 2016). It is therefore quite clear that section 7 no longer works as intended - to be an anti-avoidance measure. The opposite is now happening as high net worth individuals are able to use this to their advantage. They can only be taxed at a maximum of 41 per cent which is the same as a trust and if their income is less than R701 301, they can be taxed at anything from 0 per cent to 41 per cent. Therefore, the anti-avoidance rules are now being used to avoid tax, which is the opposite

effect for which they were intended. On the CGT side, the donor would be taxed at the individual effective rate of 16.40 per cent whereas the trust would be at 32.80 per cent, an obvious benefit (Davis Tax Committee, 2015:38).

There is a further benefit for trust donors in that the attribution of income from a trust is deemed income and has no effect on the donor's estate for estate duty purposes. This study is not looking into the effects of estate duty so no further analysis will be conducted in this regard.

The DTC recommendations with regards to trusts will now be analysed separately.

Trust tax rate

The trust tax rate was increased to 41 per cent in the 2015 year of assessment and it is recommended by the DTC that it should stay at this level.

As the main goal is to increase tax revenue by removing the conduit principle and to tax trusts as a separate taxpayer, further increases in the trust tax rate could provide more tax for the fiscus.

Section 7 and 25B: Residents

The DTC recommends that the deeming provisions in section 7 and section 25B be repealed when it comes to resident trusts (Davis Tax Committee, 2015:39). These are the deeming provisions that effectively make the trust a look-through vehicle for tax purposes. By removing these the conduit principle would no longer apply and the trust would be taxed as a separate entity.

Trust as a separate taxpayer

What the DTC is implying here, is that the conduit principle should be removed and any income received by the trust should be taxed in the trust as a separate taxpayer before distribution to beneficiaries. Taxpayers are currently in a position where they can split

income between beneficiaries and leave nothing in the trust, therefore avoiding tax by taking advantage of lower individual tax rates.

Citadel (2015) has stated that if the current attribution principles are removed it will result in trusts being taxed at 41 per cent and capital gains included at 66.6 per cent (now 80 per cent after the 2016 budget speech). They feel it is very high compared to other South African entities. With the current ability to split income amongst beneficiaries the tax effect in practice is not that bad compared to other entities but if the attribution principles are removed, it would turn out to be quite discriminatory.

Submissions by the public on the first interim report on estate duty was due by 30 September 2015 and some of the recommendations were not well received (Schubert, 2015).

The public did not like the idea of removing the conduit principle as it would be disregarding the historic development of the taxation of trusts. Schubert (2015) notes that the real issue to be identified is the non-disclosure of income and capital gains by beneficiaries of resident and non-resident trusts. If the administration of trusts were to be improved so that additional revenue was collected, there would be no need to remove or change existing provisions that apply to trusts.

In a South African Institute of Tax Professionals (SAIT) webinar held in December 2015, Judge Dennis Davis indicated that some of the DTC's recommendations have changed since the public's comments on the first interim report. He mentioned that the DTC did not deal with trusts correctly in the first report and that the conduit principle will probably be retained with regards to distributions to beneficiaries from local trusts. Greater emphasis will be placed on undisclosed income and capital gains from non-resident trusts. SARS implemented the Voluntary Disclosure Programme (VDP) with the hope that non-compliant taxpayers would come forward and disclose previously undisclosed income. This has not been working to the extent that SARS had been hoping. A first step in possibly increasing revenue collection is to improve compliance from these non-resident

trusts by ensuring that beneficiaries in South Africa disclose their vested income and capital gains from offshore (Schubert, 2015).

Judge Dennis Davis mentioned that the second interim report on estate duty would be released in January 2016 but there has been no release at the time of completion of this dissertation. The recommendations were to be announced in the 2016 budget speech but as the second interim report has not been released, the recommendations will most probably be announced in the 2017 budget speech.

Even if the DTC does not go ahead with the recommendations to repeal section 7 and section 25B, it would be beneficial to see how this could affect employee share scheme trusts and specifically dividends received.

6.3 Effect these changes will have on employee share scheme trusts

It would be prudent to ascertain how the recommendations on section 7 and section 25B from the DTC could affect trusts in general, and more specifically dividends in relation to employee share scheme trusts.

By removing the deeming provisions in section 7 and section 25B, effectively the conduit principle, trusts would be taxed as separate taxpayers. Trustees will no longer be in a position to distribute income and capital gains to beneficiaries in a discretionary trust and beneficiaries with vested rights to income and capital gains in a vesting trust could possibly only receive distributions after tax has been deducted in the trust.

The various forms of income received by the trust, be it rental, interest or dividends as well as capital gains may lose their identity on distribution once received by the trust and taxed. Previously a trust could distribute to beneficiaries and the various forms of income would retain their identity in the hands of the beneficiaries but a trust may only be able to distribute income to beneficiaries after it is taxed in which case it will be a normal income distribution if in the same year of assessment. With the trust being taxed on all income and capital gains received, one would need to look at possible ways to provide

deductions or exemptions to the beneficiaries as it could create double tax scenarios if the income is taxed in the trust and then also included in the taxable income of the beneficiaries.

In the context of dividends received by a share incentive trust and distributed to beneficiaries of the scheme, the DTC recommendations could have significant effects. Certain Share Incentive Trusts (SITs) are created solely for employees of a company to be rewarded by receiving dividends on shares held by the trust. If the conduit principle no longer exists, then the dividends received by the trust will be subject to dividends withholding tax and the net amount will be reflected in the trust financials. After the trust taxable income has been calculated and the applicable tax has been paid, the net amount can be distributed to the beneficiaries. The dividends would no longer retain their identity and the distribution to beneficiaries would be normal income.

A more detailed analysis of the DTC recommendations with specific calculations on all taxes will be conducted as part of a case study in Chapter 7.

7 Case studies

7.1 Introduction

A good way to illustrate the various tax implications from an employee share scheme trust would be to present hypothetical case studies. The aim is to analyse an employee's participation in a share incentive trust and take a closer look at the different tax implications according to the Income Tax Act No. 58 of 1962 (ITA) as it currently stands, as well as the possible tax implications of the recommendations from the Davis Tax Committee (DTC) in its first interim report on estate duty.

The same set of facts will be used for both scenarios whereby an employee will subscribe for shares in a South African resident company through a share incentive trust also registered in South Africa.

7.2 Case study 1 – Share incentive trust (current tax treatment)

7.2.1 Facts

John Black is an employee of XYZ (Pty) Ltd, a private company that is resident in South Africa. XYZ (Pty) Ltd decides to create a share incentive trust (SIT) called the ABC Trust for the purpose of subscribing for shares in the company and holding the shares for the benefit of the employees. The ABC Trust would manage and oversee the employee share scheme on behalf of the company. XYZ (Pty) Ltd issues 100 000 shares to the ABC Trust, and simultaneously grants a loan to the trust to finance the issue of the shares. The year of assessment for both entities runs from 1 March to 28 February.

On 1 March 2012, the trust grants John Black the right to acquire 1 000 shares at a price of R300 per share. The following restrictions are attached to the acquisition of the shares:

- John Black must remain in the employment of XYZ (Pty) Ltd for a period of three years after the acquisition date.

- John Black cannot freely dispose of the shares for a period of four years after the acquisition date.

John Black decides to take up the offer and exercises his right to acquire the 1 000 shares on 1 March 2012.

XYZ (Pty) Ltd declared the following dividends over the period:

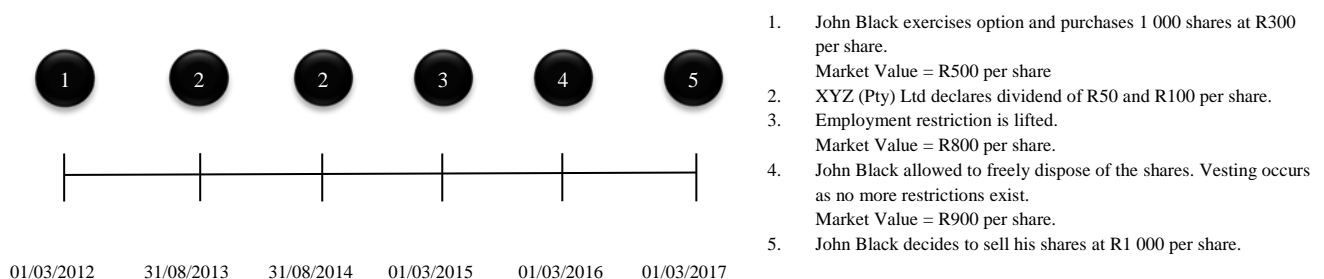
- 31 August 2013 – R50 per share
- 31 August 2014 – R100 per share

On 1 March 2015, the employment restriction lifted as John Black remained in the employment of XYZ (Pty) Ltd for the three year period as stipulated in the agreement and he would be able to freely dispose of the shares on 1 March 2016. John Black decides to keep the shares for an additional year and sells all 1 000 shares on 1 March 2017.

Market value per share on relevant dates:

- 1 March 2012 – R500
- 1 March 2015 – R800
- 1 March 2016 – R900
- 1 March 2017 – R1 000

Share Incentive Trust Timeline



7.2.2 Application of current tax law

Prior to the Taxation Laws Amendment Act (TLAA) of 2013, National Treasury thought about taxing dividends paid to employees via employee share scheme trusts as normal income. However, they never implemented this as it was asserted that it would negatively affect the ultimate beneficiary of these schemes, the low-income employees. It is common practice to form employee share scheme trusts for a large number of low-income employees and by taxing these dividends, it would have a negative impact as the actual cash received would be lower as a result of taxing the dividends as normal income (Ger, 2013).

Prior to 12 December 2013 when the TLAA of 2013 was promulgated, section 10(1)(k)(i)(ii) of the ITA was not yet applicable and local dividends received from employee share schemes would only be subject to section 10(1)(k)(i)(dd) of the ITA.

The current stance is that dividends are exempt, except for:

- Dividends received or accrued by a person in respect of services rendered or to be rendered
- Dividends received by virtue of employment or holding of office (other than in respect of a restricted equity instrument as defined in Section 8C)

The addition of section 10(1)(k)(i)(ii) to the ITA coming from the TLAA of 2013, is a provision to deal with dividends received in respect of services rendered or by virtue of employment.

This addition indicates that a dividend from a restricted equity instrument will still qualify for the exemption. As discussed in Chapter 4, even if the dividend is in the form of a disguised salary, it would seem that it is still exempt and only if it is an unrestricted equity instrument will the dividend be taxed as normal income.

Let's look at the tax implications of the case study set out above.

1. XYZ (Pty) Ltd offers John Black the right to acquire shares in XYZ (Pty) Ltd via the SIT. For section 8C to apply, John Black must be in the employment of XYZ (Pty) Ltd and have been granted the right to acquire shares as a result of his employment. It must be determined whether a trust can be regarded as an employer under section 8C as they are the entity issuing the shares on behalf of XYZ (Pty) Ltd. As per the 'employer' definition in section 8C, the trust needs to be an employer as contemplated in paragraph 1 of the Seventh Schedule. The Seventh Schedule specifically deals with benefits derived by reason of employment or the holding of any office. The 'employer' definition refers to the definition in the Fourth Schedule which states that an employer can be a person who administers a benefit fund therefore, the share trust falls within the definition (Jonas, 2012).

When John Black exercises his right to acquire the 1 000 shares at R300 per share on 1 March 2012, the gain is taxable as per paragraph (c) of the gross income definition that is included in section 1 of the ITA. The gain made would be the market value at 1 March 2012, less the purchase price, times the number of shares. This works out to a gain of R20 000. However, it will be exempt from tax in terms of section 10(1)(nD) as vesting has not occurred due to the equity instrument still being restricted.

2. The R5 000 dividend received on 31 August 2013 is prior to the effective date of the new section 10(1)(k)(i)(ii) which is 1 March 2014. Therefore, section 10(1)(k)(i)(dd) would have to be applied. This section states that a dividend will not be exempt from normal tax if it is in respect of a restricted equity instrument, unless one of the three exceptions applies. At 31 August 2013, the shares are still restricted as the two restrictions are still applicable, therefore the dividend could be taxable as normal income. After analysing section 10(1)(k)(i)(dd) in Chapter 4, it is clear that section 10(1)(k)(i)(dd)(A) would apply, and any dividend received that relates to a restricted equity instrument and constitutes an equity share will be exempt from normal tax. The only tax applicable would then be Dividend Withholding Tax (DWT) at 15 per cent on R5 000 which comes to R750.

The dividend declaration on 31 August 2014 would be subject to the new section 10(1)(k)(i)(ii). As the shares are still restricted they are a restricted equity instrument and therefore the dividend is exempt in terms of section 10(1)(k)(i)(ii).

If, for example, a dividend was declared on 31 August 2016 which is after the vesting date, there would be a different outcome. The shares would now be classed as unrestricted equity instruments and section 10(1)(k)(i)(ii) would not apply. You would have to determine whether the dividends received, were directly linked to services rendered or by virtue of employment. If they were, then the section would apply and the dividends would not be exempt from normal tax.

As discussed in Chapter 4, it is still unclear whether the intention of National Treasury is to tax dividends on unrestricted equity instruments as normal income. For a share to become unrestricted, it would have been already taxed as a gain on the vesting date, therefore a situation of double taxation could occur as any resulting dividends would also be taxed as the legislation only refers to restricted equity instruments being exempt. Only if the unrestricted equity instrument constitutes a share directly held would it be exempt. The TLAA of 2013 states further that this only applies to shares directly held by the employee, therefore in a situation where the employee doesn't hold the shares directly, but on the employees behalf through a SIT, this requirement for it to be a share directly held is not met (Spamer and Treurnicht, 2013). As a result, this situation creates a position where the dividend will be taxed as normal income once the shares become an unrestricted equity instrument.

3. At the point the employment restriction is lifted, the gain on the shares would be R50 000 (R800 market value less R300 purchase price). Although the employment restriction has lifted, John Black still cannot freely dispose of the shares until 1 March 2016. The shares still remain restricted equity instruments and vesting has not yet occurred. The gain is still exempt as per section 10(1)(nD) of the ITA.

4. On 1 March 2016 the final restriction has lifted and John Black is able to freely dispose of his shares. As per section 8C(3)(b)(i), when all restrictions cease to have effect, the equity instrument acquired by the employee is deemed for the purposes of this section to vest in that employee. This is the point where income tax and PAYE arises.

In normal circumstances when shares are sold (other than an employee share scheme share), the gain would be subject to capital gains tax (CGT) and taxed as such in the hands of the employee. When a gain is made on vesting as per section 8C, it will be included as gross income. As per section 8C(2)(a)(ii), the gain to be included in the income of the employee is the amount by which the market value of the equity instrument at vesting date exceeds the original purchase price.

This would be calculated as R900 market value on 1 March 2016 less R300 original purchase price which gives a total gain of R60 000 on vesting date. The gain would then be included in the gross income of the taxpayer and taxed at the marginal tax rate.

5. On 1 March 2017 when John Black decides to sell his shares, the market value is at R1 000 per share. As per paragraph 20(1)(h) of the Eight Schedule, the base cost of the share will be the market value that was used on the vesting date of the equity instrument as contemplated in section 8C of the ITA. Therefore, the capital gain will be calculated as the difference between the current market value (R1 000) and the market value at date of vesting (R900). The capital gain of R10 000 will be included in the taxpayers income at the 40 per cent inclusion rate for the 2017 year of assessment.

7.2.3 Outcome

The tax consequences for John Black will be DWT on both dividend payments and normal tax on the gain made on vesting date. The R5 000 dividend on 31 August 2013 was exempt from normal tax as per section 10(1)(k)(i)(dd)(A) but still subject to DWT and the R10 000 dividend on 31 August 2014 was exempt from normal tax as per section 10(1)(k)(i)(ii), but still subject to DWT. The capital gain would be reduced by the annual exclusion which is currently R40 000, assuming there were no other capital gains, it would be reduced to nil. Assuming a basic tax rate of 18 per cent, the tax payable by John Black on the gain made on vesting would be R10 800 (R60 000 x 18 per cent). The DWT on the dividends would be R2 250 (R5 000 x 15 per cent) + (R10 000 x 15 per cent).

There will be some confusion with regards to the new section on dividend exemption as it is not known whether the provision will apply to restricted equity instruments where it is not a share but rather a contractual right to the dividends attached to the shares. There is also no indication whether the section 10(1)(k)(i)(ii) will apply to dividends after the restricted equity instrument has vested. Once it has vested and the relevant tax has been paid according to section 8C, will the dividends received by the employee now be subject to normal tax? This could result in double taxation (Faurie, 2014).

7.3 Case study 2 – Share incentive trust (hypothetical tax treatment based on Davis Tax Committee recommendations)

7.3.1 Facts

John Black is an employee of XYZ (Pty) Ltd, a private company that is resident in South Africa. XYZ (Pty) Ltd decides to create a share incentive trust (SIT) called the ABC Trust for the purpose of subscribing for shares in the company and holding the shares for the benefit of the employees. The ABC Trust would manage and oversee the employee share scheme on behalf of the company. XYZ (Pty) Ltd issues 100 000 shares to the ABC Trust, and simultaneously grants a loan to the trust to finance the issue of the shares. The year of assessment for both entities runs from 1 March to 28 February.

On 1 March 2012, the trust grants John Black the right to acquire 1 000 shares at a price of R300 per share. The following restrictions are attached to the acquisition of the shares:

- John Black must remain in the employment of XYZ (Pty) Ltd for a period of three years after the acquisition date.
- John Black cannot freely dispose of the shares for a period of four years after the acquisition date.

John Black decides to take up the offer and exercises his right to acquire the 1 000 shares on 1 March 2012.

XYZ (Pty) Ltd declared the following dividends over the period:

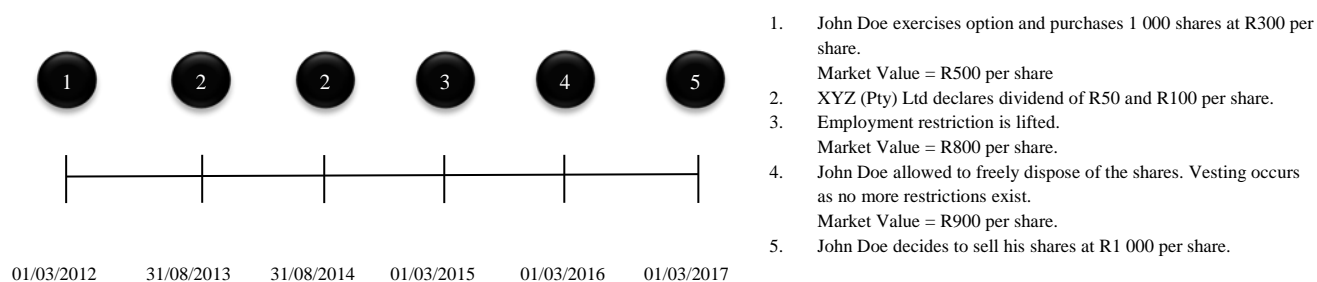
- 31 August 2013 – R50 per share
- 31 August 2014 – R100 per share

On 1 March 2015, the employment restriction lifted as John Black remained in the employment of XYZ (Pty) Ltd for the three year period as stipulated in the agreement and he would be able to freely dispose of the shares on 1 March 2016. John Black decides to keep the shares for an additional year and sells all 1 000 shares on 1 March 2017.

Market value per share on relevant dates:

- 1 March 2012 – R500
- 1 March 2015 – R800
- 1 March 2016 – R900
- 1 March 2017 – R1 000

Share Incentive Trust Timeline



7.3.2 Application of proposed changes by the Davis Tax Committee

The recommendations by the DTC to repeal section 7 and 25B of the ITA and to tax trusts as separate taxpayers could have significant tax implications.

An analysis will now be conducted of the tax implications of the case study set out above, taking into account the DTC recommendations.

1. The same scenario is applicable to John Black as in point 7.2.2. XYZ (Pty) Ltd offers John Black the right to acquire shares in XYZ (Pty) Ltd via the SIT.

When John Black exercises his right to acquire the 1 000 shares at R300 per share on 1 March 2012, the gain is taxable as per paragraph (c) of the gross income definition that is included in section 1 of the ITA. The gain made would be the market value at 1 March 2012, less the purchase price, times the number of shares. This works out to a gain of R20 000.

However, it will be exempt from tax in terms of section 10(1)(nD) as vesting has not occurred due to the equity instrument still being restricted.

2. The dividend declaration on 31 August 2013 would be subject to section 10(1)(k)(i)(dd)(C) and be exempt from normal tax but still subject to DWT. The problem that could arise from the DTC recommendations is that the dividends will no

longer flow through the SIT and into the hands of John Black as a beneficiary. The SIT would be taxed as a separate taxpayer and all forms of income in the SIT will lose its identity after being taken into account in the taxable income computation of the SIT.

The dividend declaration of R100 per share on 31 August 2014 would be subject to section 10(1)(k)(i)(ii). As the shares are still restricted they are a restricted equity instrument and therefore the dividend is exempt from normal tax in terms of section 10(1)(k)(i)(ii) but still subject to DWT. As is the case with the first dividend, the dividends will not flow through the SIT to John Black.

3. The same scenario is applicable to John Black as in point 7.2.2. The gain on the shares would be R50 000 (R800 market value less R300 purchase price). The employment restriction has lifted, but John Black still cannot freely dispose of the shares until 1 March 2016. The shares remain restricted equity instruments and vesting has not yet occurred. The gain is still exempt as per section 10(1)(nD).

The DTC recommendations would have no effect at this stage.

4. On 1 March 2016 the final restriction is lifted and John Black is able to freely dispose of his shares. As per section 8C(3)(b)(i), when all restrictions cease to have effect, the equity instrument acquired by the taxpayer, in this case the SIT on behalf of the employee, is deemed for the purposes of this section to vest in that taxpayer. The gain made on vesting will be included as gross income. The gain is the amount by which the market value of the equity instrument at vesting date exceeds the original purchase price.

This would be calculated as R900 market value on 1 March 2016 less R300 original purchase price which gives a total gain of R60 000 on vesting date. The gain would

then be included in the gross income of the taxpayer and taxed at the marginal tax rate.

The issue now is that the actual gain on vesting is with the SIT as it holds the shares on behalf of the employee beneficiary. This gain will no longer flow through the SIT to the beneficiary. As the SIT is seen to be a separate taxpayer, the gain would be included in the income of the trust and taxed at the trust tax rate of 41 per cent instead of the marginal tax rate of the beneficiary, which could be significantly lower.

5. On 1 March 2017 when John Black decides to sell his shares, the market value is at R1 000 per share. As per paragraph 20(1)(h) of the Eight Schedule, the base cost of the share will be the market value that was used on the vesting date of the equity instrument as contemplated in section 8C of the ITA. Therefore, the capital gain will be calculated as the difference between the current market value (R1 000) and the market value at date of vesting (R900). The capital gain of R10 000 will be included in the taxpayers income.

If the DTC recommendations were to apply, the capital gain would not flow through to the beneficiary but remain in the SIT. The capital gain inclusion rate for the SIT would be 80 per cent compared to the 40 per cent for individuals and the SIT cannot make use of the R40 000 annual exclusion.

7.3.3 Outcome

The final outcome for John Black and the SIT will be quite different to that of the first case study. With the DTC recommendations taken into account, there would still be DWT on both dividends but they would not flow through to him from the SIT. The gain made on vesting would be included in the SIT's taxable income and taxed at 41 per cent instead of in John Black's hands at his marginal rate of tax. The capital gain would be included in the SIT's taxable income at an inclusion rate of 80 per cent and would not be eligible to be reduced by the R40 000 annual exclusion. Based on the above, it would seem that

John Black would not be liable for any tax as all the income and capital gains would be taxed in the SIT.

The overall tax paid would also be much higher. The gain on vesting date of R60 000 would be taxed at 41 per cent giving a tax paid amount of R24 600. This is R13 800 more than if it were to flow through to John Black. The capital gain of R10 000 would be included in the SIT's taxable income at 80 per cent. This R8 000 would also be taxed at 41 per cent which gives a tax payable amount of R3 280. If the capital gain were to flow through to John Black, it would only be included at 40 per cent and he would be able to make use of the R40 000 annual exclusion which would reduce the amount to zero.

7.4 Conclusion

Based on the above analysis, if the DTC recommendations were to be adopted, SIT's would no longer work as dividends, income and capital gains cannot flow through the SIT to the beneficiaries. The overall tax consequences would also not be in the taxpayers favour. The total tax payable in terms of the current legislation is R2 250 DWT and the R10 800 on the gain made on vesting date. The total tax payable taking into account the DTC recommendations is R2 250 DWT, R24 600 on the gain made on vesting date and R3 280 on the capital gain made on sale date. This is a total difference of R17 080 which is more than double the tax as per the current legislation.

8 Conclusion, recommendations and areas of future analysis

8.1 Summary

The objective of this study was to analyse the tax effects of dividend payments from employee share scheme trusts. This was achieved by discussing trusts, various employee share schemes models, looking at most of the definitions and provisions in section 8C and certain provisions in section 10(1)(k) of the Income Tax Act No. 58 of 1962 (ITA) and understanding dividends as well as dividends withholding tax. A brief analysis of United Kingdom employee share schemes was also conducted to be able to compare the tax effects in another country. The recommendations on the taxation of trusts by the Davis Tax Committee (DTC) was also considered as they could have significant tax effects with regards to employee shares scheme trusts. Lastly, working through two case studies, one with the current tax treatment and one incorporating the DTC recommendations, helped to demonstrate the tax consequences in both scenarios.

After the Taxation Laws Amendment Act (TLAA) of 2013, it would seem that dividends from restricted equity instruments are still being treated as exempt dividends. Only when a direct or indirect link can be established between employment and the declaring of the dividend will section 10(1)(k)(i)(ii) apply and when the equity instrument is unrestricted, it will result in the dividend not being exempt from normal tax. Based on the discussion in Chapter 3 and 4, a conclusion was reached that there is still some uncertainty concerning the tax effect of dividends received from unrestricted equity instruments. Due to the fact that there is no case law and that section 10(1)(k)(i)(ii) is relatively new, there is very little guidance to assist with the implementation of this section.

The DTC recommendations discussed in Chapter 6 would change the way taxpayers use employee share scheme trusts in the future if implemented. By removing the conduit principle, the repeal of section 7 and section 25B, and taxing trusts as separate taxpayers, beneficiaries of Share Incentive Trusts (SIT) would no longer be able to benefit from the flow through principle. The case studies conducted in Chapter 7 shows the tax effects as

they are now and if the DTC recommendations were to be implemented and it is clear from the study that there will be more tax payable overall if the recommendations are to be adopted.

8.2 Recommendations

After analysing the areas discussed above and conducting the two case studies, I have come to the same conclusion expressed by the community regarding the tax effect on dividends from employee share schemes. Section 10(1)(k)(i)(ii) of the ITA that was introduced in 2013 has added another level of complexity. Although its intention is to curb disguised salaries in the form of dividends, it resulted in more uncertainty as the provisions are not very clear and do not apply to all dividends received in respect of services rendered or by virtue of employment. The section only refers to restricted equity instruments and makes no mention of what will happen after vesting date, therefore the public is left to speculate on the treatment of dividend payments when the underlying equity becomes an unrestricted equity instrument.

It seems unfair that employees who receive disguised salaries as dividends from restricted equity instruments are exempt from normal tax as per section 10(1)(k)(i)(ii) but if it is received in relation to an unrestricted equity instrument, then section 10(1)(k)(i)(ii) does not apply and the dividend will be subject to normal tax. It would be beneficial if National Treasury could issue an Interpretation Note or clearer legislation to bring some clarity to the matter or even address this in later Taxation Law Amendment Acts if it is found to be an oversight. Perhaps a system similar to what has just been introduced in the United Kingdom with regards to Dividends will help curb taxpayers disguising salaries as dividends. National Treasury could look at implementing a tax free limit of dividends received, R50 000 for example, and then anything above R50 000 will be subject to dividend withholding tax or normal tax.

The recommendations on the taxation of trusts proposed by the DTC could cause a major shift in the use of employee share scheme trusts in the future. Without the conduit

principle, beneficiaries of Share Incentive Trusts may lose out if the trust is taxed as a separate taxpayer. National Treasury and the DTC could consider how these trust recommendations will affect employee share scheme trusts as it seems the main focus is only improving administration of trusts and revenue collection from undisclosed income and capital gains from non-resident trusts. The repeal of section 7 and 25B could have a knock on effect, whereby section 8C and 10(1)(k) may have to be amended.

At the date of completion of this dissertation in July 2016, the second interim report on estate duty is expected sometime this year so it will be interesting to see how the recommendations have changed and if any other aspects regarding trusts have been considered. It will also be important to note if any of the recommendations are incorporated into the TLAA of 2016.

8.3 Areas of future analysis

This paper only looked at a limited set of scenarios surrounding dividend payments from a share incentive trust. Analysing other types of share schemes could result in different tax consequences and outcomes when it comes to dividends. The effects for foreign dividends and non-resident taxpayers were also not analysed. Dividend payments to non-resident taxpayers would fall under different provisions in the ITA. This is an area where this study could potentially be developed further.

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