

University of Cape Town

Masters in Commerce (South African Tax)

Department of Finance and Tax

Date: 31 January 2021

Topic: the income tax consequences of the clawback of shares in the context of employee share schemes

Word count: 24,999

Abstract: The objective of this dissertation is to examine the income tax consequences of the clawback of shares awarded in terms of employee share schemes in South Africa in terms of the Income Tax Act 58 of 1962 as amended (“the ITA”). The dissertation first examines how section 8C of the ITA would apply in the context of clawback, and concludes that in certain circumstances clawback will postpone the tax vesting date. It then examines the capital gains tax implications of clawback provisions, which hinge on the interpretation of section 8C and the legal nature of clawback respectively. The tax implications of clawback in respect of cash-based payments is another area of focus, and generally clawback will only delay the taxing point if it is framed as a suspensive condition. The tax implications for the employer and employee respectively are then assessed. It concludes that where the employer has claimed a deduction upon settlement, when the award is subsequently clawed back, only the value claimed as a deduction should be included in the employer’s income. Where an employee claims a deduction for the amount which is clawed back (where the employer withheld Employees’ Tax), a concomitant tax deduction may be available in certain circumstances. Ambiguities in the existing tax law (which may lead to unintended consequences) are then considered, and it is suggested that

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certain amendments to section 8C may resolve some of the ambiguities. The final chapter summarises the key findings.

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1. Chapter 1: introduction

1.1. Background

The South African (“SA”) corporate sector, in particular companies listed on the Johannesburg Stock Exchange (“JSE”), has come under pressure in recent years to curb what are sometimes perceived as bloated levels of executive remuneration (PwC, 2016: 34). To contextualise this, the structure of an executive director’s (or “executive’s”) remuneration package in a listed SA company would include shares awarded in terms of a company’s employee share scheme (Madlela, 2018: 46). An employee share scheme usually provides that executives or other selected employees may receive an award which confers the right to acquire shares in their company (also referred to as “share awards”), in order to align their interests with those of the shareholders (Institute of Directors Southern Africa, 2012: 11). Depending on the structure of the employee share scheme and the financial fortunes of the company concerned, share awards have the potential to yield dividends as well as lucrative returns for executives and are thus subject to intense public scrutiny – these returns are thrown into sharp relief where wrongdoing on the part of the executive is revealed years after the share awards have fully vested in the executive (Madlela, 2018: 46-47).

Executives usually have to meet certain performance conditions set by the board of directors which are measured over a period of time or stay employed by the company for a certain period (these conditions sometimes run concurrently). When the company is satisfied that the executives should become unconditionally entitled to the share awards, each executive can register the underlying shares in his or her own name and thereafter trade with or dispose of them. The day on which the executive becomes fully entitled to the share awards is usually referred to as the vesting date, as the phrase is defined in the constitutive rules of the share plan. Clawback is a quasi-contractual mechanism whereby a company imposes a resolute condition on

share awards after they have been released by the company to the executive. The clawback condition typically provides that the company reserves the right to demand that the executive return the shares awarded to him or her through the employee share scheme, or alternatively for the company to recover the shares from the executive, if certain events (referred to commercially as “trigger events”) occur (Madlela, 2018: 46). These trigger events vary from company to company, but could include, for example, a material misstatement of financial results (which can, in some instances, be fault-based); gross misconduct on the part of the executive; or a material failure of risk management in the company as a whole, or in the executive’s business unit (PwC, 2015: 11).

Some major SA companies listed on the JSE have introduced clawback provisions over share awards made to executives. To date, there is no record of clawback provisions having been enforced in an SA court, and there is no guidance from the South African Revenue Service (“SARS”) that sets out its approach to clawback provisions. However, there are increasing accounts of corporate misconduct in the media, which typify the trigger events that would merit the application of clawback provisions (for an example, see National Treasury, 2017: 2). One may speculate that it is only a matter of time before listed companies will come under pressure to enforce the clawback provisions that they have adopted; and when these provisions are enforced, companies and individual executives will need to understand the tax consequences of recovering these share awards.

1.2. Research question/objective

The crisp question is: what are the SA income tax consequences of clawback conditions for shares awarded in terms of employee share schemes, focusing on employee share schemes and clawback conditions typically found in SA listed financial services companies? The objective of this dissertation, therefore, is to examine the income tax consequences of the clawback of

shares awarded in terms of employee share schemes in SA in terms of the Income Tax Act 58 of 1962 as amended (“the ITA”). Where necessary this dissertation will also cite examples from the United States of America (“USA”), in particular due to the available commentary from scholars in that jurisdiction regarding the application of tax principles where clawback is applied; as well as the legal nature of clawback itself (i.e. whether its application means that the monies recovered from the employee were never rightfully earned by him or her in the first place). The USA also has developed regulations through the Dodd-Frank Act requiring publicly traded companies to introduce clawback provisions (Broshuis, 2012: 186), which helps in understanding the application of tax principles to such clawback provisions; whereas SA does not have the benefit of similar legislation when considering the application of the ITA. The legal principles are useful to understand from a CGT perspective (as will be explained in chapter 3). However, the objective is not to apply or import the USA tax implications of clawback into SA wholesale, merely to provide guidance on the possible tax consequences in SA.

This dissertation will explore the tax implications of clawback by applying the legal principles in the ITA to two alternative scenarios. This is necessary because clawback provisions have not been previously applied in the SA courts; and therefore there are no existing scenarios that show how the relevant ITA provisions have been definitively applied, that can be relied on in this dissertation. The scenarios include two typical sets of facts in which clawback provisions could plausibly be applied. It is acknowledged that these scenarios do not envisage every possible circumstance in which the tax implications of clawback could become applicable – that would not be possible. Rather, they are meant to enrich the discussion of the principles herein and illustrate possible changes in circumstances that could affect the tax treatment of equity instruments that are subject to clawback. Once the ITA principles, particularly the submissions on the interpretation of existing provisions in the ITA to clawback events, have been set forward in each chapter, the interpretations will be applied to the scenarios in order to illustrate how the ITA would hypothetically impact a taxpayer where clawback is actually enforced.

Please note that these scenarios are separate and distinct from one another. The analysis will apply the ITA and other relevant statutes, including any legislative changes, as it stood at 31 March 2020.

1.3. Parameters of the scenarios

1.3.1. Scenario 1: background facts

In this scenario, the hypothetical taxpayer (“Robert”) is an employee of Sugar Corporation Limited (“SugarCorp”), a fictional JSE listed company. Robert receives a cash bonus from the company once a year. The payment of this bonus is contingent on the achievement of certain predetermined performance conditions – should the Company achieve a certain target, Robert will become entitled to receive a cash amount from the company (the quantum of which is determined beforehand). SugarCorp claims a tax deduction for the cost of paying bonuses to its employees, including Robert. Robert received a R2,000,000 bonus on 31 December 2018. The constitutive rules of the bonus scheme include clawback provisions, which specify that if Robert causes reputational harm to the Company or is found guilty of gross misconduct and/or fraudulent conduct within 3 years after the date of payment of the bonus, the Company reserves the right to recover all or a part of the cash amount that it paid to him. This rule applies even if Robert achieved the performance targets for the bonus payment. If Robert is no longer employed by SugarCorp during the 3 year clawback period and one of the trigger events occurs during that time, the company will still attempt to recover the cash amount from him.

SugarCorp administers a Share Appreciation Rights (“SARs”) scheme, which is governed by a set of constitutive plan rules which comply with the JSE Listings Requirements. The scheme operates as follows:

1. On the award date, the employee receives a SAR award;

2. He or she must remain employed by the Company for 3 years after the award date;
3. If he or she remains employed for the full 3 year period, the SARs vest in him. The date of vesting will be the third anniversary of the award date;
4. After the vesting date, the employee can exercise the SAR award for 4 years, which then allows them to receive shares; and
5. If the employee exercises the SAR award, the employee receives shares. If the employee does not exercise the award within the 4 year period, the SAR lapses.

The salient features of the scheme are summarised below.

Structure: certain employees (or participants) are awarded SARs that entitle them to receive shares in SugarCorp after the vesting period. These SARs, once exercised, entitle the participant to receive shares equal in value to the difference between the strike price (a fixed notional price of the underlying shares based on the closing share price of SugarCorp on the date on which they are awarded) and the share price on the date on which the participant exercises the SARs.

Notional strike price: R10

Vesting period: 3 years. In order to receive shares under this scheme, the participant is not required to meet any performance conditions over a 3 year period; but the participant must fulfil the employment condition over that period (i.e. remain employed by the company). At the end of the 3 year period, and assuming that the employment condition has been met by the participant, the participant will receive shares which can be traded on the market. This is not to be confused with 'vesting' in the technical sense.

Consideration: the participant does not have to pay any consideration for the shares, unless the shares are worth less than the notional strike price on the exercise date.

Settlement: equity settled. The participant will receive actual shares in SugarCorp on the vesting date (as it is defined in the plan rules), which will be registered in the participant's name.

Performance conditions: none

Lapse period: 7 years from the award date (after which any unexercised SARs will lapse).

SugarCorp administers the SARs through the SugarCorp Incentive Trust, a trust created specifically for this purpose. As SARs are remuneration as defined in paragraph 1 of the Fourth Schedule of the ITA, SugarCorp claims a corporate tax deduction for the cost of settling the SARs to participants (if it purchases shares off the market to do so). After exercising the vested SARs, the participant is free to retain or sell the shares, as the case may be.

The awards of SARs to participants are subject to a clawback provision. This entitles the Company to recover any shares that vested (in terms of the plan rules) to the participant for a 3 year period after the date on which the SARs are exercised. This will apply if it emerges that, during the 3 year period, he was either guilty of gross misconduct (based on the findings of an internal disciplinary hearing); or there was a material misstatement of SugarCorp's financial results for which he was wholly or partly responsible. The constitutive plan rules set out the methods of recovering the shares from the participating employee, once a trigger event has occurred. The Company could institute legal proceedings against the participant to recover these shares; or alternatively the Company could withhold the cash value of the shares from any subsequent payments due to the participant. However if the trigger event does not occur during the 3 year clawback period, the Company will no longer have any right of recourse against the shares held by the employee. If the employee resigns from the Company during the 3 year clawback period, the Company will still attempt to recover the shares from him or her. The employee is entitled to sell or otherwise alienate the shares during the 3 year clawback period.

On 01 January 2016, Robert was awarded 50,000 units in the SugarCorp Incentive Trust. The vesting period ran from 01 January 2016 to 31 December 2018. Robert remained employed at SugarCorp throughout the vesting period, and therefore the SARs vested (as defined in the SAR constitutive plan rules) in him on 31 December 2018. The clawback period ran from 01 January 2019 to 31 December 2022. He exercised the SARs on 20 February 2020. On 09 June 2020, Robert was accused of gross misconduct. The SugarCorp board of directors instituted internal disciplinary proceedings against him, following which SugarCorp successfully instituted legal proceedings against him to recover 100% of the shares that he acquired from exercising the SAR award; as well as 25% of the bonus which was paid to him on 31 December 2018, which amounted to R500,000.

In this scenario, cash bonuses have been included in order to illustrate the income tax consequences of clawback for cash-based payments made to employees.

1.3.2. Scenario 2: background facts

As stated above, the hypothetical scenario set out below is mutually exclusive from scenario 1.

Accra Corporation Limited (“AccraCorp”) is an investment holding company listed on the JSE. An employee, Sarah, is eligible to participate in the short-term incentive and long-term incentive respectively. The short-term incentive is a cash amount that is paid out after the end of its financial year (i.e. after 31 December), the quantum of which is determined at the discretion of the Remuneration Committee, and which is subject to certain predetermined performance conditions. The long-term incentive is a conditional share plan,

which is governed by a constitutive set of share plan rules which comply with the JSE Listings Requirements. The scheme operates as follows:

1. The employee is given the right to acquire shares if he or she fulfils certain conditions;
2. The shares will vest in the employee if he or she remains employed during the vesting period, and certain performance conditions have been met, during that vesting period; and
3. If the predetermined conditions are met after three years, the employee will acquire the shares. The employee can then dispose of the shares.

The salient features of the plan are set out below.

Structure: participants are awarded rights to shares in AccraCorp after the end of the vesting period (as the term is defined in the constitutive share plan rules), provided that certain performance conditions are met. The number of shares that will be given to the employee once the performance conditions have been met is set at the beginning of the vesting period (as defined in the constitutive plan rules). No consideration is payable by the participant in exchange for the shares.

Strike price: none

Vesting period: 3 years. In order to receive shares under the scheme, the participant must fulfil certain performance conditions over a 3 year period. At the end of the 3 year period, if the conditions have been met by the participant, the employee will receive shares which he or she may thereafter trade with. The participant must also remain employed by the company for the full 3 year period. This is not to be confused with 'vesting' in the tax technical sense. The participants do not receive dividends or voting rights on the unvested conditional rights during the vesting period.

Settlement: equity settled. The employee will receive actual shares in AccraCorp on the vesting date (as it is defined in the plan rules), which will be registered in the employee's name.

Lapse period: not applicable. The participants will automatically receive the shares when the performance and vesting conditions have been met, and it is not necessary for the participants to exercise any rights to receive them. Similarly, there is no lapse period associated with the shares.

As the conditional shares are remuneration as defined in the Fourth Schedule, to the extent that AccraCorp purchases shares off the market to settle the vested conditional shares, it claims a tax deduction from SARS for the cost of doing so. Upon receiving the shares on the legal vesting date, Sarah is free to retain or sell the shares.

The awards of conditional shares are matched with a clawback provision, which entitle the Company to recover any awards paid to Sarah for 3 years after the vesting date if it emerged that, during the 3 year clawback period, she was guilty of gross misconduct (based on the findings of an internal disciplinary hearing); or there was a material misstatement of AccraCorp's financial results during the 3 year period for which she was wholly or partly responsible. The Company could institute legal proceedings against Sarah to recover these shares; or alternatively the Company could withhold the cash value of the shares from any subsequent payments due to Sarah. If Sarah disposes of the shares during the clawback period, the Company reserves the right to recover the cash equivalent of the shares, with reference to the closing share price of the shares on the date that the relevant trigger event occurred.

On 01 January 2016, Sarah was awarded 10,000 conditional shares in AccraCorp. The vesting period ran from 01 January 2016 to 31 December 2018. She remained employed at AccraCorp throughout the vesting period. The predetermined performance conditions were partially met. Therefore, a

proportionate number of the conditional awards vested in her on 31 December 2018. The clawback period will run from 01 January 2019 to 31 December 2022. In June 2020, AccraCorp found that Sarah was responsible for the misstatement of financial results and successfully instituted legal proceedings against her to recover 60% of the shares that she acquired as a result of the conditional share award which vested in December 2018.

1.4. Areas of research

In terms of section 8C(3)(b)(i) of the ITA, equity instruments vest when all restrictions cease to have effect. One of the questions that this dissertation will address is whether the imposition of a clawback condition when the share award is made to the executive (otherwise known as the “award date”) imposes such a restriction. Some clawback provisions do not appear to have a set period over which they apply (after which the clawback provisions will no longer apply to the share awards), implying that they apply to those shares indefinitely. This may be due to poor drafting or disclosure on the part of listed companies. However, some may argue that a clause of indefinite duration may be necessary because the trigger events, for example a corporate scandal implicating an executive in wrongdoing, may arise years after the executive resigns or retires from the company. In those circumstances, if this dissertation concludes that the effect of the clawback condition is to postpone vesting in terms of section 8C, the related question is whether loosely drafted clawback provisions can postpone tax vesting indefinitely.

This dissertation will also examine whether the taxpayer should be entitled to a refund of tax previously paid, or whether he should be entitled to receive a tax deduction in respect of the year of assessment in which the shares are forfeited or clawed back. If so, the question is how the tax deduction in question should be calculated by SARS – in particular, if the value of the tax deduction be based on the amount of tax paid on the date when the shares were released to the employee, or when they were recovered from the employee by the

company (Melone, 2010: 82). Section 10(1)(nE) of the ITA is irrelevant to this question, as it explicitly excludes transactions in terms of section 8C from its ambit.

This dissertation will also examine the capital gains tax (“CGT”) implications of clawback, specifically whether the imposition of a clawback provision postpones or otherwise impacts the date of acquisition of a share award for CGT purposes; and whether the occurrence of a trigger event, or the enforcement of clawback provisions by the company gives rise to a disposal in terms of paragraph 11(1)(b) of the Eighth Schedule of the ITA (Melone, 2010: 87).

The paper will also set out the tax consequences of clawing back cash payments or bonuses paid to executives (to the extent that these are instructive to the question posed in this dissertation); however it will not consider the tax consequences of share awards that have been awarded by a foreign entity to an SA individual. It will also examine the tax consequences where the individual executive has already disposed of the shares and by virtue of the operation of the clawback provisions, must repay a cash amount equal to the pre-tax market value of the shares (in lieu of returning the shares themselves).

This dissertation will consider the tax consequences for the company if it previously claimed a tax deduction of the cost of the shares in terms of section 11(a) of the ITA, and has subsequently clawed back those shares. For the purpose of this analysis, this dissertation will assume that the company purchases its own shares off the market to settle the share awards and does not issue shares or use treasury shares.

Based on the conclusions reached on the points above, this dissertation will then proceed to identify specific tax issues that should be addressed in order

to prevent any unintended consequences that may arise in respect of cash- or equity-settled incentives which are subject to clawback provisions. Where appropriate, this dissertation will also state whether these issues should be subject to further study in a separate dissertation.

1.5. Research method

In order to investigate the questions posed above, this dissertation will include research in the area of legal interpretative research, in particular the doctrinal method of research, by forming a more complete understanding of the conceptual bases of clawback, and the combined effect of various provisions in the ITA as they relate to clawback. In so doing, it will examine the following sources:

- Primary sources including case law, legislation and the common law, from SA and, to the extent that it is useful, from selected foreign jurisdictions (which are set out in the paragraphs below).
- Persuasive authority, for example decisions from the Tax Courts, and guidance from SARS in the form of binding rulings, interpretation notes, etc.
- Secondary sources, e.g. journal articles appearing in peer reviewed journals on clawback and the tax consequences thereof, in SA (where available) and in the USA.

Where appropriate, this dissertation will consider the tax legislation and case law around the tax implications of clawback in the USA. This selection is based on the fact that the USA has developed laws and draft regulations surrounding clawback conditions over employee share schemes, and any guidance that is available on the tax consequences thereof would be instructive. When examining these jurisdictions, care will be taken because in the USA, the introduction of clawback provisions for publicly listed companies is mandated

by legislation (Melone, 2010: 58; Broshuis. 2012: 186; Melone, 2013: 72), whereas in the SA context, clawback is imposed by certain companies of their own accord, who are not compelled to do so by statute.

This dissertation will not conduct a full comparative study of the USA tax law. In order for this treatise to be of any value, it cannot place too much emphasis on a jurisdiction whose tax legislation applicable to employee share schemes would have different principles and nuances. Where necessary, this dissertation will cite insights from the USA where it would be instructive to do so; but ultimately, this dissertation will place its focus on the tax implications of clawback in the SA context.

1.6. Limitations of the scope

1.6.1. Legal enforcement

This dissertation will not preoccupy itself with the intricacies of the legal enforcement of clawback. It will be assumed for the purposes of this dissertation that clawback can be enforced through settlement out of court, voluntary compliance by the executive concerned, or legal action. However, this dissertation will consider the basic legal underpinnings of clawback clauses, to the extent that it is relevant to do so in order to interpret the tax consequences.

1.6.2. Companies in other sectors

The dissertation will focus on clawback of equity instruments awarded in terms of share incentive schemes by private sector companies, specifically listed companies. It will not focus on the tax consequences of clawback of remuneration paid in specialised sectors, e.g. state-owned enterprises.

1.6.3. Malus

The dissertation will, to a very limited extent, consider the tax implications of malus, or ex ante risk adjustment, on share awards where the executive is not entitled to trade freely with the shares, as a potential remedy to the scenarios above.¹ The focus will be placed on the recovery of share-based awards and cash payments from the executive concerned, where the executive has an unencumbered right to alienate the cash or share-based awards.

1.6.4. Securities Transfers Tax

This dissertation will not cover the implications of Securities Transfer Tax ("STT") in instances where clawback has been effected; it will only focus on the ITA.

1.6.5. Broad-based employee share plans

This dissertation will not discuss the income tax consequences of section 8B of the ITA which governs the taxation of amounts that vest in employees in terms of broad-based employee share plans.

1.6.6. Individual tax returns

This dissertation will not examine the administrative requirements of filing an individual tax return which reflects the tax credit or the refund due over tax paid on clawed back shares, as the case may be (Melone, 2010: 90).

¹ Malus refers to the reduction of unvested cash or share awards, through the introduction of an additional vesting condition on the awards. Where malus provisions are invoked, it effectively means that if certain trigger events occur (e.g. during the vesting period, the employee is found guilty of gross misconduct by an internal disciplinary committee), the unvested share award will be reduced by the board by a certain percentage, and the portion thus reduced will be treated as having lapsed when calculating the number of shares which are to vest in the participant.

1.7. Structure of the dissertation

The following section sets out the structure of this dissertation. Where necessary the relevant law will be applied to the scenarios outlined above to demonstrate the application of particular points of law. This first chapter introduces the research topic by providing background, placing the research objective in context and explaining the importance of understanding the tax consequences of clawback; and thereafter sets out the structure of the dissertation.

The second chapter examines the tax consequences of clawback for share awards as well as cash-based payments which fall within the definition of “equity instrument” in section 8C(7) of the ITA, specifically whether clawback constitutes a restriction as defined in section 8C(7), that will affect the taxable event.

The third chapter assesses the CGT implications of clawback, focusing on the imposition of the clawback provision (usually on the date that the awards vest); as well as whether the occurrence of a trigger event or enforcement of clawback gives rise to a disposal in terms of the Eighth Schedule.

The fourth chapter discusses the tax consequences of clawback provisions over cash payments or bonuses paid to executives, including where an executive must repay a cash amount equal in value to the pre-tax value of the shares that were awarded and subsequently sold after the vesting date.

The fifth chapter examines the tax consequences for a company if it claimed a deduction for the cost of settling the share awards to the executive, and thereafter clawed those shares back.

The sixth chapter examines the tax position of the executive after the successful enforcement of a clawback clause against cash or share awards, and whether the executive is entitled to a tax deduction or refund for Employees' Tax withheld on the share awards.

The seventh chapter contains a two-pronged discussion. Firstly, it considers whether there are any unintended tax consequences that may arise from the conclusions reached in the previous chapters, or alternatively whether there are any lacunae in the ITA that do not adequately address the income tax consequences of clawback; and secondly, if the first question is answered in the affirmative, whether it is necessary to amend section 8C in order to cater specifically for clawback.

The eighth chapter contains a crisp answer to the question posed in the introduction of this dissertation, and summarises the findings in the dissertation relating to the tax consequences of clawback. It will also pose questions arising from this subject for future exploration by other scholars.

2. Chapter 2: the interpretation of section 8C of the ITA

2.1. Background

This chapter addresses whether the imposition of a clawback provision on the award date of a share-based award constitutes a restriction in terms of section 8C of the ITA. If the imposition of clawback constitutes a restriction, it will postpone vesting for tax purposes. This will also include the tax consequences of clawback for share awards as well as cash-awards, which fall within the definition of section 8C(7) of the ITA. The chapter will, after setting out the limitations of this analysis, set out the necessary sections of section 8C, and explain why SARs and conditional awards respectively would constitute “restricted equity instruments” as defined. It will then consider how certain parts of the definition of “restricted equity instruments” should be interpreted in the context of clawback, specifically whether clawback results in “forfeiture” of ownership (as contemplated in section 8C(7)) otherwise than at market value; or constitutes a financial penalty; and the section 8C consequences of clawback provisions which are of an indefinite duration. It will then set out the comparable USA position, followed by a summary and the application of the principles to scenarios 1 and 2.

2.1.1. Limitations of section 8C analysis

Note that clawback in the context of transactions falling within sections 8C(4), (5) and (6) will not be explored further. This limitation is based on the fact that section 8C(4) deals with the disposal of a restricted equity instrument in circumstances which include a disposal –

“for an amount which consists of or includes any other restricted equity instrument in the employer of the taxpayer or an associated institution in relation to the employer, that other restricted equity instrument

acquired in exchange is deemed to be acquired by that taxpayer by virtue of his or her employment or office of director of any company.”

It is submitted that this section does not directly deal with the meaning of a restriction, which is critical to determining the tax implications of clawback on equity instruments. Sections 8C(5)(a)(i) and (ii) apply to transactions completed in certain circumstances, which include instruments acquired –

(a) otherwise than by or under a disposal made in terms of a transaction at arm’s length;

[...]

but it does not define a restriction, forfeiture or market value. The same rationale applies to sections 8C(5)(b) or (c), and section 8C(6) which contain deeming provisions. This dissertation will examine disposals of restricted equity instruments by virtue of forfeiture, and paragraph (a) of section 8C(5)(c) specifically excludes these circumstances from subsection 8C(5).

The reference to legislation in section 8C would, according to the interpretation of this subsection, exclude clawback provisions (where explicitly or effectively) which were imposed by statute. This dissertation does not deal with the existence or the interpretation of such legislation, although research indicates that it does not exist in SA at present (Madlela, 2018: 47). Therefore, this aspect will not be explored further.

The subsection in the definition of market value in section 8C(7) dealing with private companies has been excluded on purpose, as clawback in private companies will not be dealt with in this dissertation.

2.2. Section 8C provisions in the context of SARs and conditional awards

The relevant provisions are quoted in full below.

“8C. Taxation of directors and employees on vesting of equity instruments

[...]

(3) An equity instrument acquired by a taxpayer is deemed for the purposes of this section to vest in that taxpayer –

[...]

(b) in the case of the acquisition of a restricted equity instrument, at the earliest of –

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

(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);

[...]

(7) For purposes of this section, unless the context otherwise indicates –

[...]

‘equity instrument’ means 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;

“market value” in relation to an equity instrument –

[...]

- (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;

‘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; or
- [...]
- (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;...”

Section 8C(3)(b) of the ITA confirms that vesting for tax purposes occurs on the date that all restrictions on the equity instrument (as defined) lift, or when the restricted equity instrument is disposed of. The use of the word “or” in the subsections of the ITA set out above indicates that section 8C may apply in each of the alternate circumstances set out above; so if a restriction does not fall within paragraph (a) of the definition of a restricted equity instrument, but could result in the forfeiture of ownership in terms of paragraph (b)(i) above, the instrument will still be restricted. The definition of “equity instrument” in section 8C(7) includes the right to a cash-settled award made to an employee, the quantum of which is determined with reference to the value of a share in a company (Silke, 2018: para. 4.73C).

Before considering the definition of “restricted equity instrument” in the context of clawback, it is necessary to consider whether SARs or conditional share awards constitute restricted equity instruments as defined. As contemplated in paragraph (b) of the definition of an ‘equity instrument’, a SAR is a personal right in favour of the employee. Upon exercise, the right is cancelled and the employee becomes entitled to receive equity instruments which are equal in

value to the difference between the strike price and the market value of the instrument on the exercise date. Silke comments that under a SAR plan, 'the employee receives the benefit while unilaterally being able to ignore any potential loss' (Silke, 2018: 4.73C). It is correct that an employee cannot be compelled to exercise SARs where the strike price of the SAR exceeds the market value (the SARs simply lapse if left unexercised for a certain period). The SAR can only be exercised by the employee once certain predetermined conditions have been met. Therefore, SARs are considered restricted equity instruments as defined in section 8C. Furthermore, although they can be exercised, SARs do not require an employee to actually pay consideration in exchange for the shares; instead, the employee acquires shares equal to the difference between the strike price (set on the award date) and the share price on the date of exercise. Therefore although they are not options, they are still option-type instruments as their value is determined with reference to a strike price.

Turning to the nature of conditional awards, these are contractual rights or obligations in favour of the employee, the value of which are determined directly or indirectly with reference to a share or member's interest – therefore they are equity instruments as defined in section 8C. The conditional award is not deliverable to the taxpayer until the happening of an event, whether fixed or contingent. This can be the fulfilment of a performance condition or an employment condition (depending on the rules of a particular plan), and the conditions would be specified when the conditional awards are granted to the employee. The shares would only vest in the employee if the event upon which vesting was contingent was fulfilled; therefore, as conditional awards would remain subject to a restriction (i.e. a performance or employment condition) preventing the taxpayer from freely disposing of the underlying shares until such time as the condition is fulfilled, they would be considered restricted equity instruments as defined in section 8C.

The following subsection deals with how certain parts of the definition of “restricted equity instruments” should be interpreted in the context of clawback. The point of departure is that a “restricted equity instrument” is subject to any restriction that prevents the taxpayer from freely disposing of the equity instrument at market value (Section 8C(7)). Therefore, a clawback provision that requires that the taxpayer retain the shares in an escrow account for the duration of the clawback period would prevent a taxpayer from freely disposing of the equity instrument.

A related question is whether a clawback provision would prevent the taxpayer from freely disposing of the equity instrument at market value, where the clawback provision does not prevent a taxpayer from actually disposing of the equity instruments. The word “freely” implies that the taxpayer may dispose of the equity instrument as he or she wishes – but not necessarily without any future consequences. It is submitted that this paragraph does not create a section 8C restriction on that basis where the clawback provisions do not preclude disposal of an equity instrument.

In the context of section 8C(3)(b)(i)-(iii), if the taxpayer disposes of a restricted equity instrument (and accepting the proposition that the clawback provision constitutes a restriction for tax purposes), vesting will be deemed to have occurred. The subsequent enforcement of a clawback provision, therefore, could result in the taxpayer returning the monetary value of pre-tax shares to the company. The tax consequences of doing so will be discussed in more detail later on in the dissertation. The restriction will also be deemed to have lifted when all of the restrictions cease to have effect in terms of section 8C(3)(b)(i) – in other words, if a resolutive condition is in effect, the condition would need to be discharged or expire in terms of the contract.

2.3. The effect of clawback on the market value of a restricted equity instrument

If the definition of “market value”, in the case of a restricted equity instrument, refers to the price which could be obtained had the restriction not existed, then the question is whether clawback would affect whether an employee disposing of an equity instrument to a willing buyer can do so at its market value, because the instrument is subject to clawback. There is no empirical data available in SA to assess whether this is, in fact, the case. It is submitted that, in theory, clawback would not affect the purchase price of the vested equity instrument. At a high level, if the clawback provisions allow for the company to recover the equity instrument *from the employee*, or a cash amount equal in value to the market value of that equity instrument, it could be argued that recourse against the employee would involve invoking a personal right that would not affect the third-party purchaser. Therefore, there is no clear reason why the presence of a clawback provision would affect the market value of an equity instrument as defined in section 8C.

Based on the assertions above, clawback does not always result in a restriction on the disposal of an equity instrument. Some clawback provisions allow the employee to freely dispose of the underlying shares during the clawback period; therefore they cannot be classified as a restriction in terms of section 8C on that basis. If, however, the clawback provision requires the executive to retain the shares in an escrow account as a precondition of receiving ownership of the shares, then this would impose a section 8C restriction.

2.4. Interpretation of the words relating to the forfeiture of ownership

It is worth examining if clawback results in “forfeiture” of ownership as contemplated in section 8C. The word “forfeit” is not defined in the ITA. The Oxford English Dictionary (“forfeit”, 2019) defines the verb “forfeit” as follows:

“1.1 Lose or give up (something) as a necessary consequence of something else”.

In the case of clawback, the employee would run the risk of losing ownership of the equity instruments, if one of the trigger events occurs within the clawback period. The fact that the clawback may not be utilised at all, i.e. none of the trigger events may emerge during that clawback period, does not eliminate the risk of forfeiture during that period.

2.5. Interpretation of the words “otherwise than at market value”

The words “otherwise than at market value” imply that the employee would forfeit the equity instruments and either receive consideration which would be less than market value; or receive no compensation at all. In the case of clawback, this would mean that the employee would forfeit the shares (or a cash amount calculated with reference to the market value of the shares) to the company. If a clawback provision were to be invoked, the company would not compensate the employee for the value of the shares thus forfeited – therefore, the employee would forfeit the shares for an amount otherwise than their market value. For the company to compensate the employee in these circumstances would thwart the stated purpose of clawback, which is to recover shares from an employee who should by rights have never received them (Madlela, 2018: 48). Therefore, a clawback provision which puts an equity instrument (as defined in section 8C) at risk of forfeiture for a value other than market value would make the instrument a restricted equity instrument.

2.6. Interpretation of the words “penalised financially”

The phrase “penalised financially” is not defined in the ITA. The adverb “financially” is defined in the Oxford English Dictionary (“financially”, 2018) as follows:

“In a way that relates to finance”.

The verb “penalise” is defined in the Oxford English Dictionary (“penalise”, 2018) as:

“1 Subject to a penalty or punishment”.

This implies that:

- (i) The employee would be subject to a penalty or punishment. By extension, this would allude to some wrongdoing on the part of the employee.
- (ii) The penalty would be rendered in a way that relates to finance.

The financial penalty as contemplated in the definition of “restricted equity instrument” would have to be as a result of failing to comply with the conditions precedent of acquiring the equity instrument, or with resolute conditions imposed over the equity instrument. In the vast majority of instances, an equity instrument will have some pecuniary value. By extension, therefore, the forfeiture of such an instrument would result in a penalty to the taxpayer that is financial in nature – the taxpayer may not necessarily withdraw money to settle the liability (unless he has already disposed of the equity instrument), but the value of his personal estate could be reduced if ownership of the equity instrument must revert to the company.

Regarding the imposition of a penalty or punishment, there should be a direct link between an action or inaction attributable to the employee; and the company’s decision to recover the equity instrument. For example, if the clawback is merited by the restatement of the company’s financial results

which is attributable to the taxpayer's wrongdoing, the subsequent clawback of the equity instruments may constitute punishment for failing to comply with the terms of the agreement. However, where the clawback is merited by the restatement of the company's financial results, through no fault of the taxpayer, one could argue that the taxpayer is not being penalised financially for not complying with the terms of the agreement for the acquisition of the instrument (as contemplated in section 8C), because the recovery is not a method of punishing the employee concerned. Therefore, barring any other restrictions, it is possible that in these specific circumstances, clawback will not constitute a restriction in terms of section 8C.

To conclude, clawback may not impose a restriction where (a) the employee can freely dispose of the shares during the clawback period, (b) the employee will not forfeit the shares for an amount less than market value, and (c) the employee is under no threat of financial penalty as a result of certain suspensive or resolute conditions. On the other hand, the inability to trade with the shares during the clawback period will constitute a restriction. Where the employee can trade with the shares freely but the company can recover them (or the value thereof) from the employee without compensating the employee, the clawback provision can impose a restriction. Where the clawback provision requires payment by the employee, or otherwise reduces the employee's estate, this can constitute a financial penalty and therefore a section 8C restriction. Where the forfeiture is a result of a penalty where the employee failed to fulfil a suspensive condition, or meet a resolute condition, then the clawback provision would constitute a penalty for section 8C purposes.

2.7. Consequences where the clawback provisions do not have a set period over which they apply

Based on the provisions above, it is necessary to consider what the tax consequences will be where the clawback provisions appear to apply

indefinitely. This may be due to poor drafting, in which case the courts would need to ascertain the intention of the parties when they entered into the contract that governed the award of equity instruments, that were implied terms (*LAWSA 2014: para. 358*). Specifically, the court would need to apply the bystander test (*Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration* [1974] 3 All SA 497 (A) at 522) and ask “did the parties intend for the clawback provisions to apply for the duration of the employee’s tenure of the company?” If the answer is yes, then applying the interpretation of section 8C as set out above, the equity instruments would be taxed upon disposal of the equity instrument, or on termination of the employee’s tenure or office at the company (depending on the intention of the parties).

It is necessary to also deal with clauses where the clawback provisions are actually meant to continue indefinitely, including after termination of employment. Although a clawback provision which applies in perpetuity seems excessive, it is conceivable that some companies could take this approach. It can take years before instances of corporate wrongdoing are finally unearthed.

In these circumstances, it is possible that the restriction on the equity instrument will continue for years after the equity instrument has vested in terms of the constitutive plan rules, as it remains at risk of forfeiture until the end of the employment period. The question is whether that section 8C restriction will continue after the termination of employment. Where the employee retains ownership after termination of employment, it is possible, since the risk of a financial penalty continues after the employee has resigned. However, there has to be a *risk* involved for the employee concerned – the wording used is “any restriction that could result in the taxpayer...”. Therefore, if there is no risk that the clawback provision will be enforced by the company after the employee resigns, for example because the employer has not explicitly reserved the right to do so, then it is submitted that the risk does not

constitute a restriction, as the forfeiture 'could' not occur after termination of employment.

Outside of the circumstances set out above, it is hard to conceive a situation where the restriction will continue after the end of employment, barring the obvious legal and practical issues associated with trying to enforce such a provision. However, a contract is void on the ground of impossibility of performance only if the impossibility is objectively absolute (*LAWSA*, 2014: para. 331). Mere difficulty in making performance does not prevent a valid contract from arising (*LAWSA*, 2014: para. 331). Impossibility can only extend to legality, if it is legally impossible for the party to do so because the law does not recognise or make provision for the performance (*LAWSA*, 2014: para. 331). It can be argued that clawback could be enforceable after termination of employment, thereby making it possible for the resolutive condition to be fulfilled; in which case, the section 8C restriction could continue indefinitely. The unintended consequences thereof will be discussed in more detail later on in the dissertation.

2.8. USA

According to Melone, the point of departure is that the USA tax consequences of clawing back compensation are tied to the tax treatment of the compensation that is clawed back (Melone, 2010: 59). Melone notes that rescission of contract is not directly analogous to clawback, on the basis that typically in the USA, "clawbacks do not arise from a rescission of a contract; to the contrary, clawbacks may be triggered under the terms of the contract" (Melone, 2010: 79). The contractual nature of clawback in SA has yet to be tested in the local courts, but the USA view provides useful insight on the subject.

In the USA, taxpayers cannot amend their income tax returns in prior income tax years (the claim-of-right doctrine), where the compensation paid to them in that year of assessment has been clawed back; rather, they must claim a deduction for the compensation and benefits that they repaid to the company, in that year of assessment (Melone, 2010: 84).

Claiming a deduction will depend on whether, factually, the taxpayer is carrying on a business or trade; and whether the expenditure (i.e. the repayment to the company) is necessary or voluntary (Melone, 2010: 84 – 86).

Turning to deferred compensation, those plans that are subject to an objective, non-discretionary clawback feature (e.g. a restatement of earnings) will be subject to section 409A² (Melone, 2010: 99). That said, if the clawback provisions incorporate a vague or discretionary trigger event, section 409A may not apply (Melone, 2010: 99).

Cash repayments made under a clawback provision, may also benefit from section 1341 in certain circumstances, which will make the value of the tax deduction upon repayment equal to the reduction in tax that the taxpayer would have had if the recovered compensation was not included in their income in the previous year of assessment (Melone, 2010: 91; 100 – 101; Melone, 2013: 76).

Underwater stock-based compensation that is not subject to deferral is exempt from section 409A (Melone, 2010: 103). Internal Revenue Code (“IRC”) Section 83(a) effectively allows the postponement of taxation, and the general rule that “the actual or constructive receipt of property in exchange for services is a taxable event at the time the property so received is transferable by the recipient or not subject to a substantial risk of forfeiture, whichever occurs

² Section 409A will allow the taxpayer to postpone their incidence of taxation for deferred compensation plans, provided that they meet certain requirements (Melone, 2010: 97).

earlier” (Melone, 2010: 104). The amount of income recognised from such a transaction is the difference between the market value of the assets and the compensation paid (if any) in exchange for the assets (Melone, 2010: 104); but this could expose the taxpayer to significant tax if the value of the stock increases between the grant date and the vesting date (Melone, 2010: 105). This is a similar test to that imposed by section 8C of the ITA. There must be a material risk of forfeiture, either through the imposition of performance or employment-related conditions (Melone, 2010: 104).

2.9. Chapter summary

Section 8C(3)(b) of the ITA confirms that as a point of departure, vesting for tax purposes occurs on the date that all restrictions on the equity instrument are lifted, or upon disposal of the restricted equity instrument. SARs and conditional share awards are equity instruments as defined, and suspensive or resolute conditions imposed can result in restrictions. Where a clawback provision requires an employee to retain the equity instrument during the clawback period, it constitutes a section 8C restriction. There is no evidence that clawback itself would affect the market value of an equity instrument. Where clawback applies over a fixed period, then the restriction would end when the clawback period ends, depending on the intention of the parties. Where clawback lasts indefinitely, the restriction would end upon disposal of the equity instrument. When clawback is exercised, the employee will forfeit the instrument at less than market value as it is unlikely that he or she will be compensated at all upon forfeiture or repayment of an amount to the employer. Where the employee is penalized financially, it is submitted that a clawback provision will impose a restriction where it constitutes punishment for events attributable to the employee. The USA position is that the tax consequences of applying clawback in that jurisdiction are tied to the tax treatment of the compensation that is clawed back.

2.10. Scenario 1

In the absence of other section 8C(7) restrictions, the taxing point for the hypothetical SAR would arise on the date on which it was exercised. SugarCorp successfully recovered the actual shares that Robert acquired by exercising his SARs. The taxing point for those shares had not yet arisen at the time that he exercised the SARs, as they were subject to clawback until 31 December 2023, which constituted a section 8C(7) restriction. The legal vesting date (in terms of the plan rules) had already arisen independently of section 8C, and therefore the trust releasing the shares to Robert during the clawback period did not affect the taxing point. The shares remained restricted in terms of section 8C, based on the following:

- The restriction would only have been lifted if the clawback period had run its course without incident. However, during the clawback period, the company instituted disciplinary proceedings against Robert based on a trigger event.
- It could be argued that the restriction ended upon expiry of the clawback period, and the clawback period was a resolute condition that was imposed as a requirement for the equity instrument to vest in terms of section 8C. However it is submitted that the disciplinary and subsequent legal proceedings must be resolved in order for the equity instrument to vest for tax purposes. It cannot be the date of the trigger event – after all, it may take years for it to be discovered, or to conclude legal or disciplinary proceedings. The imposition of clawback (even without reference to pre-existing wrongdoing) is sufficient to delay the taxing point for the equity instrument, as the restriction amounts to an imposition of a financial penalty. The disciplinary and legal proceedings have the same effect, even if they are only resolved after the clawback period has ended.

Based on this conclusion, no tax should have been withheld on the equity instruments once they were released to Robert, as they were still restricted for section 8C purposes. That said, pragmatically it is possible that the trust would have withheld the Employees' Tax from the equity instruments upon settlement to Robert. The possibility of Robert claiming a tax deduction is dealt with in a separate chapter.

2.11. *Scenario 2*

As the performance conditions were suspensive conditions for vesting (in terms of the plan rules of the scheme), Sarah only became entitled to the conditional shares once she met the performance conditions. Based on the assertions above, the allegation of Sarah's negligence in June 2020 means that the clawback acted as a penalty.

The incident occurred after the vesting period and led to the trigger event arising. She chose to retain the shares during the clawback period, although she could trade with them freely. The company did not compensate her for the shares that it recovered; therefore she forfeited the shares for an amount less than their market value. Under these circumstances, the conditional shares were restricted equity instrument – so until the legal proceedings are resolved, Employees' Tax cannot be withheld from the awards as the vesting point has not yet arisen.

3. Chapter 3: the CGT implications of clawback

Based on the findings in chapter 2, this chapter considers the CGT implications of clawback. Please note that this dissertation will only deal with the tax implications of equity instruments that are granted to employees after 01 October 2001. The chapter will begin by considering the contractual nature of the enforcement of clawback; followed by the relevant ITA provisions and paragraphs of the Eighth Schedule that deal with the CGT implications of section 8C instruments, including in the context of employee share scheme trusts. The CGT implications of clawback will then be explored, based on the interpretation of the relevant provisions. The chapter will then set out the tax treatment of returns of capital on section 8C instruments (and the impact of clawback thereon), followed by a discussion on whether a capital loss is claimable where the taxpayer forfeits the monetary value of the shares (in lieu of the shares themselves). The chapter will then consider whether the occurrence of a trigger event constitutes a disposal. The USA position will be considered, followed by a summary of the key findings. The interpretations of the law will then be applied to the two scenarios.

3.1. Legal nature of the enforcement of clawback

When assessing the applicability of the ITA and the Eighth Schedule to clawback, it is necessary to consider (at a high level) whether exercising a clawback provision constitutes a termination, cancellation or rescission of the contract between the company and the taxpayer, due to the significant implications associated therewith.

The question is whether clawback constitutes a breach of contract (which would then lead to restitution) (LAWSA, 2014: para. 363). While this dissertation does not seek to examine the complexities around this topic, if the clawback provisions are framed as negative potestative conditions (i.e. “you

must refrain from gross misconduct for a fixed period of time”) and these are not met by the employee, one could argue that the employee’s failure to fully adhere to the terms of the agreement amounts to a breach of contract.

If clawback does amount to a breach, is rescission the legal consequence of clawback? A creditor is entitled to rescind a contract if the other party’s breach of their obligations affects a “vital part” of the contract (*LAWSA*, 2014: para. 407); and the intention to rescind is clearly communicated to that party (*LAWSA*, 2014: para. 425). A successful rescission renders the contract void *ab initio*, and

“each party must restore the other to the position that they would have been in had they not entered into the agreement” (*LAWSA*, 2014: para. 426).

Restitution *in specie* (i.e. a substitute for the original performance received from the other party) will be accepted where returning the original performance is not possible (*LAWSA*, 2014: para. 427).

It is submitted that whether or not clawback constitutes a rescission will depend on how the particular clawback provision has been drafted. It is submitted that enforcing clawback cannot be restitution if the employee paid consideration for the equity instruments, which the company is not compelled to refund if clawback will be exercised. Furthermore, the company may determine that only a part of the shares will be clawed back after the trigger event; therefore, it is questionable whether the breach can be said to strike at the heart of the contract (*LAWSA*, 2014: 407) if a substantial part of the contract remains in place. The employee’s performance conditions were stipulated in the plan rules and / or award letter, and the employee may not be otherwise provided with restitution for those services rendered.

Based on the above, it may not be accurate to characterise clawback as a rescission leading to restitution; however, this is a matter that is worth investigation by other scholars in separate bodies of work.

3.2. The current position

Section 8C(1)(b) states the following:

“8C Taxation of directors and employees on vesting of equity instruments

(1)

(b) This section does not apply in respect of any equity instrument which –

(i) was acquired by the exercise or conversion of, or in exchange for the disposal of, any other equity instrument where this section applied in respect of the vesting of that other equity instrument before that exercise, conversion or exchange;...

Section 8C(1)(b)(i) would apply where an equity instrument (including a share option or SAR) is exercised or converted in order to acquire a share or member's interest in a company. The question is whether exercising a SAR that is subject to clawback results in the acquisition of a restricted or unrestricted equity instrument. Although the position is unclear, it is submitted that section 8C(1)(b)(i) envisages a situation where there are no further section 8C restrictions on the instrument acquired through (inter alia) the exercise of a SAR, where section 8C had applied to the SAR itself. Therefore, if a SAR is used to acquire an equity instrument that is subject to clawback after the

exercise date and we accept the premise that a clawback provision can amount to a restriction in the context of section 8C(7), the equity instrument thus acquired is a restricted equity instrument.

Regarding the other relevant provisions of the ITA, section 9C(2) states:

- “(2) Any amount received or accrued (other than a dividend or foreign dividend) or any expenditure incurred in respect of an equity share must be deemed to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount or incurral of that expenditure, been held for a period of least three years.”

Section 9C(5) states the following:

- “(5) There shall in the year of assessment in which any equity share held for a period of at least three years is disposed of by the taxpayer be included in the taxpayer’s income any expenditure or losses incurred in respect of such equity share and allowed as a deduction from the income of the taxpayer during that or any previous year of assessment in terms of section 11:...”

According to SARS, section 9C does not apply while the shares are restricted, but it applies if they are unrestricted at the time of disposal (SARS, 2018a: 11). This implies that section 9C applies upon disposal where the shares are held by the taxpayer for 3 years or more, even though the shares were restricted during all or part of that period (SARS, 2018a: 11). Expenditure incurred after a share has been held for at least 3 years will also be of a capital nature (SARS, 2018a: 19).

The other relevant paragraphs of the Eighth Schedule are set out below – they will be applied further on in this chapter. Paragraph 11(1)(b) states the following:

“(1) Subject to subparagraph (2), a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes –

[...]

(b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;

[...]

(d) the vesting of an interest in an asset of a trust in a beneficiary;”

Paragraph 13 states the following:

“(1) The time of disposal of an asset by means of –

(a) A change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law is, in the case of –

[...]

(iiB) the granting by a trust to a beneficiary of an equity instrument contemplated in section 8C, the time that equity instrument vests in that beneficiary as contemplated in that section;

[...]

(ix) any other case, the date of change of ownership;”

Paragraph 20 sets out the basis for calculating the base cost of a capital asset. The relevant portions state the following:

“(1) Despite section 23(b) and (f), but subject to paragraphs 24, 25 and 32 and subparagraphs (2) and (3), the base cost of an asset acquired by a person is the sum of –

[...]

(h) in the case of –

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

[...]

(ii) any other asset-

(bb) where an amount has been included in any person’s gross income in terms of paragraph (i) of the definition of “gross income” in section 1, the value placed on the asset under the Seventh Schedule for purposes of determining the amount so included in that person’s gross income;

[...]

(dd) where an amount has been included in that person's gross income in terms of paragraph (c) of the definition of "gross income" in section 1, the value placed on the asset for the purposes of determining the amount so included in that person's gross income;

[...]

Provided that where subitem (i),(ii)(bb) or (dd) applies, that person must for purposes of this paragraph disregard any expenditure actually incurred by that person in respect of that asset prior to the date on which –

[...]

- (b) the asset was disposed of, where the amount received or accrued from the disposal is taken into account in determining the gain or loss in terms of section 8C,

which must for the purposes of this Part be treated as expenditure incurred in respect of that asset.”

3.3. Employee share scheme trusts

Paragraph 64E states the following:

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

Where a capital gain is determined in respect of the disposal of an asset by a trust and a trust beneficiary has a vested right to an amount derived from that capital gain, that trust must disregard so much of that capital

gain as is equal to that amount if that amount must in terms of section 8C be –

- (a) included in the income of that trust beneficiary as an amount received or accrued in respect of a restricted equity instrument; or
- (b) taken into account in determining the gain or loss in the hands of that trust beneficiary in respect of the vesting of a restricted equity instrument.”

If a trust grants a section 8C instrument to a qualifying employee beneficiary, this is a CGT event, but the CGT only applies when the instrument vests in the employee (Silke, 2018: para. 24.42A).

Examining the paragraphs above, on a high level it is clear that the base cost of an equity instrument in the hands of an employee would be equal to the market value of that instrument, on the date on which the restrictions on that instrument lift (SARS, 2018b: 213). Therefore if the instruments are held by an employee share trust, the trust could only disregard the capital gain from the shares held until the end of the clawback period, whereupon those gains would be taken into account in the employee beneficiary’s hands. Due to the reference in paragraph 64E to section 8C vesting, it is submitted that this is an area of uncertainty that should be addressed once the unintended tax consequences of clawback in the context of section 8C are resolved.

Applying section 9C(2) of the ITA, therefore, the trust’s 3 year holding period is measured from the vesting date as defined in the trust deed (which may include the constitutive plan rules), until the date upon which the employee beneficiary disposes of the share (SARS, 2019: 11). Paragraph 64E contains the CGT implications of the disposal of an asset by an employee share trust to employee beneficiaries (i.e. through phantom shares or units) (SARS, 2018b:

504). Paragraph 64E supersedes paragraph 80(2) of the Eighth Schedule, which deals with the tax consequences of trusts vesting assets in beneficiaries (SARS, 2018b: 587). Paragraph 13(1)(a)(iiB) is set out above.

Where a section 8C equity instrument is granted by an employee share trust to an employee, the timing of the disposal for CGT purposes will be the date that the instrument vests in the employee in terms of section 8C; and not when legal ownership is transferred. Where ownership has not yet changed and clawback is implemented against the employee concerned, ownership will never be transferred. A related question is what happens where the trust transfers possession of the underlying shares governed by the unit to the employee beneficiary because the vesting conditions in terms of the plan rules have been fulfilled. It is submitted that actual transfer of ownership in terms of paragraph 13(1)(a)(ii) will not have occurred, as the instrument has not vested for section 8C purposes. Therefore in those circumstances, the timing of the disposal event (from trust to employee) is deferred until the end of the clawback period.

3.4. The CGT implications of the imposition of a clawback provision

Applying the reasoning in chapter 2 regarding the nature of clawback as a restriction for section 8C purposes, the base cost of the equity instruments will only be determined when the clawback period itself ends – and as stated previously, this may occur years after possession or legal ownership of the actual shares has been transferred to the taxpayer.

If clawback results in a restriction as long as the clawback provision remains in effect, then the base cost in terms of paragraph 20 of the Eighth Schedule will be determined with reference to the market value of the instrument that is taken into account in determining the gain or loss on the instrument. The gain or loss will be determined on the timing of the disposal from an employee share

scheme trust to an employee, which (as set out above) will occur on the date that section 8C vesting occurs (i.e. when the clawback period ends, or the clause is enforced, whichever occurs sooner). For equity instruments that are not administered through an employee share scheme trust, if the employee disposes of the equity instruments during the clawback period, the base cost rules in paragraph 20 will apply on the date of disposal, irrespective of the presence of a clawback provision.

As set out above, section 9C states that if an equity share is held for 3 years, any gain or loss in respect thereof is deemed to be of a capital nature. However, section 9C does not apply to section 8C restricted equity instruments, even if they have been held for 3 years or more (SARS, 2019: 43; section 8C(1)(a)) – this would include instruments that are restricted by clawback. Once a share becomes unrestricted (i.e. the clawback period comes to an end, and all restrictions are lifted), any disposal of the share after that date will be subject to section 9C, provided that the other conditions have been met (SARS, 2019: 43).

Turning to indefinite clawback periods, section 9C would only apply once the shares are disposed of (provided that they were held for 3 years). There are some obvious anomalous results that arise from this approach – for example, the equity instruments would never be treated as a capital assets, even though they have been held as capital assets years after they vest for legal purposes; and returns of capital are taxed as income in terms of section 8C(1A). This is dealt with in more detail in subsequent chapters.

3.5. Whether clawback creates an asset in the hands of an employer

Another question is whether the imposition of a clawback provision creates an asset in the hands of the employer, thereby triggering a paragraph 11(1) disposal, as is the case with restraints of trade (SARS, 2018b: 834). For

restraints of trade, the employer's rights are extinguished when the restraint period comes to an end in terms of paragraph 11(1)(b), and the right is tied to the employee's right to carry on a trade (SARS, 2018b: 834). In turn, the disposal occurs on the date that the right is extinguished in terms of paragraph 13(1)(b) (SARS, 2018b: 834). With clawback, on the other hand, the employer does not have the right to impede the employee from carrying on a trade (i.e. rendering services) (SARS, 2018b: 834); rather, the employer reserves the right to reclaim an asset that it previously gave to the employee. Therefore, it is submitted that clawback provisions are not analogous to restraints of trade in this regard; this may merit further study in a separate dissertation.

3.6. Returns of capital for section 8C instruments

In terms of section 8C(1A), the receipt or accrual by a taxpayer of a return of capital or foreign return of capital (other than by way of a distribution of an equity instrument) from a restricted equity instrument must be included in the taxpayer's income for the year of assessment during which the amount is received or accrues (SARS, 2018b: 695). It is submitted that if a return of capital were to be clawed back, the employee would need to attempt to reclaim that amount as a deduction in terms of sections 11(nA) and 23(m) as it would be treated as income. The application of section 11(nA) in the context of the clawback of section 8C instruments is discussed in a separate chapter.

3.7. Is forfeiture a capital loss

Turning to capital losses, the relevant parts of paragraph 4 are set out below.

“4. Capital loss

A person's capital loss for a year of assessment in respect of the disposal of an asset –

(a) during that year, is equal to the amount by which the base cost of that asset exceeds the proceeds received or accrued in respect of that disposal;

(b) in a previous year of assessment, other than a disposal contemplated in subparagraph (c), is equal to –

(i) so much of the proceeds received or accrued in respect of the disposal of that asset that have been taken into account during any year in determining the capital gain or capital loss in respect of that disposal –

(aa) as that person is no longer entitled to as a result of the cancellation, termination or variation of any agreement, or due to the prescription or waiver of a claim or a release from an obligation or any event during the current year of assessment;

[...]

(cc) as has been repaid or has become repayable during the current year of assessment;”

If a taxpayer has disposed of the restricted equity instrument but must still repay a cash amount equal in value to the shares disposed of, it is submitted that a capital loss would not be claimable.

If the reasoning by certain commentators in the USA is accepted, who argue that enforcing a clawback provision amounts to enforcing rather than terminating the contract (Melone, 2010, 79), then paragraph 4(b)(i)(aa) cannot be relied on by the taxpayer to claim a capital loss. However if the reasoning

applied earlier is refuted, and it is proven that clawback amounts to rescission or termination (fully or partially) of the underlying contract, the relevant position should be clarified. The words “any agreement” in paragraph 4(b)(i)(aa) suggest that the agreement does not need to be exclusively with the seller in this context. The cancellation of the agreement would need to mean that the taxpayer has no further right to the proceeds of the disposal; therefore if the company only claws back the market value of the shares, and not the proceeds of the disposal, the employee cannot claim a capital loss for the amount clawed back.

Furthermore, paragraph 4(b)(i)(cc) contemplates a situation wherein the proceeds are repaid or become repayable to the purchaser of the asset (Silke, 2018: para. 24.13); not where the value of the underlying asset must be returned to the party that originally gave the asset to the taxpayer. Therefore, a capital loss cannot be claimed if clawback occurs.

3.8. The treatment of trigger events – are they disposals in terms of the Eighth Schedule

The next question is whether the occurrence of a trigger event is a disposal in terms of paragraph 11(1)(a) – (b) of the Eighth Schedule.

Silke contends that, based on Australian law, where the shareholder’s rights in the share are extinguished, there is a disposal for the purposes of the Eighth Schedule (Silke, 2018: para. 24.23). SARS takes the view that there is a ‘disposal’ only where a right of ownership in the share has been transferred (Silke, 2018: para. 24.23).

Conceptually, it must be determined whether it is possible for there to be a CGT disposal of a restricted equity instrument. It is submitted that this is only possible where the restricted equity instrument has been disposed of in terms

of section 8C(3)(b)(ii). Until such time as section 8C no longer applies to the equity instrument, any gains or losses in respect of the equity instrument are not subject to CGT. The next question is whether a trigger event will constitute a disposal on the basis that it is a decrease in value of a person's interest in (inter alia) a company or trust as a result of a value shifting arrangement. A value shifting arrangement is defined in paragraph 1 of the Eighth Schedule as follows:

“ **“value shifting arrangement”** means an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and-

(a) the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or

(b) a connected person in relation to that person acquires a direct or indirect interest in that company, trust or partnership.”

It is submitted that the occurrence of a trigger event will not (as contemplated in the definition above) precipitate a change in the rights or entitlements of the interests in that company; they will remain the same, except the instrument may be recovered by the company from the employee. Therefore a trigger event will not constitute a disposal on this basis.

3.9. USA

In the USA, it appears that employees can claim a capital loss where capital gains are clawed back to the company, subject to a monetary threshold in terms of section 1211(b) (Melone, 2010: 77, 87).

However, the tax consequences of the forfeiture of equity-based compensation are fairly complex – the value of the shares that are clawed back is based on the date on which the shares were included in the taxpayer's income (Melone, 2010: 115-116). The capital gain or loss is equal to the increase or decrease in the value of the shares after the taxing point (Melone, 2010: 116). The forfeiture of the shares, according to Melone, amounts to a sale or exchange of the shares to settle the taxpayer's liability towards the employer; therefore, the taxpayer claims a deduction based on the value of the shares on the date of forfeiture to the employer (Melone, 2010: 116). Where options are qualified (i.e. if the executive holds the shares for certain periods after the grant date or exercise date), the employee is only liable for capital gains when they sell the stock option (Shilon, 2015: 370).

3.10. *Chapter summary*

Whether or not the enforcement of a clawback provision constitutes a true rescission and restitution will depend on how the particular clawback provision has been drafted; it may be difficult to conclude that it is a restitution as the employee is not compensated for any consideration or performance rendered in return for the shares, when clawback is enforced. Applying paragraph 64E, it is submitted that a transfer of ownership in terms of paragraph 13(1)(a)(ii) will not have occurred, as the equity instrument will remain restricted as contemplated terms of section 8C. As clawback will postpone tax vesting in certain circumstances, section 9C will not apply to an equity instrument that is subject to clawback. It is submitted, furthermore, that paragraph 4(b)(i)(cc) will not avail an employee that seeks to claim a capital loss if clawback is implemented, as that provision only applies where the proceeds of the disposal become repayable to the purchaser of the asset.

Furthermore, the occurrence of a trigger event would not give rise to a disposal, as the trigger event will not precipitate a change in the rights or entitlements of the interests in that company.

3.11. Scenario 1

The Share Incentive Scheme Trust released the SARs to Robert once the performance and employment conditions have been met; however, the SARs were still subject to clawback. In this scenario, and assuming that section 9C will not apply because Robert had not held the shares acquired through exercising the SAR for 3 years prior to the date on which they were clawed back, there is effectively no section 8C taxing point in Robert's hands as the beneficiary prior to the date on which SugarCorp claws them back. Therefore, as section 8C vesting was a precondition for disregarding the capital gain, the trust cannot do so as envisaged in section 64E.

Turning to the tax implications for Robert, he arguably breached his contract by failing to avoid any activity that would give rise to the trigger events. However, in clawing back the shares that Robert acquired by exercising the SARs, SugarCorp will not make good on his performance rendered during the vesting period or make good on the notional consideration given in exchange for the SARs. Therefore, in these circumstances, the application of clawback would not be characterised as a rescission leading to restitution in integrum. Furthermore, SugarCorp's exercise of clawback is not a disposal in terms of paragraph 11.

Robert exercised the SARs on 20 February 2020. If, at the time that the shares are finally recovered after a clawback provision is enforced, 3 years have passed and Robert has held the shares that he acquired by exercising the SARs, section 9C(2) and (5) would apply and they would be treated as capital for tax purposes. This is based on the submission that the restriction created

during the clawback period would end once the clawback provision is successfully enforced.

Lastly, if Robert had sold off the shares after exercising the SARs, he would not have been able to claim a capital loss if SugarCorp had clawed back a cash amount as a substitute for the actual shares; as SugarCorp was not the third-party purchaser of the shares, nor was it clawing back the proceeds of the disposal.

3.12. Scenario 2

Sarah did not receive any return on capital on the shares which were clawed back. If she had, these would have been taxable as income. The trigger event may have constituted a breach of contract by Sarah, but as AccraCorp will not otherwise compensate Sarah for her performance rendered, this cannot be clearly categorised as rescission leading to restitution, and therefore the associated CGT implications of a restitution would not apply.

Regarding the application of section 9C(2) and 9C(5), Sarah did not dispose of any shares during the clawback period. If she had, the disposal would have been treated as income, as the clawback period would run until 31 December 2023 and she would not have held onto the shares for 3 years. If the clawback period had run its course and the restriction had lifted for section 8C purposes, however, section 9C(2) and (5) would apply and the base cost of the shares would be determined based on their market value on the vesting date.

Any recovery of cash from Sarah in lieu of the shares would not be treated as a capital loss, as these would not be proceeds recovered by the third-party purchaser – they would be a cash substitute for the original asset, which is recovered by AccraCorp.

4. Chapter 4: the tax implications of clawback for cash-based payments

This chapter sets out the tax treatment of cash payments and cash-settled equity instruments that are clawed back. The first section will set out the applicable legislation and case law regarding receipts and accruals, to the extent that it is not set out in previous chapters. It will then address the clawback implications of cash-settled equity instruments, followed by a short comparison of the USA position on the recovery of cash-based compensation. The key principles in the chapter will be summarised, and the relevant law will then be applied to the two scenarios.

4.1. The current position

The definition of gross income in section 1 of the ITA states the following:

“ **gross income**”, in relation to any year or period of assessment, means –

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident;

[...]

during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely –

[...]

- (c) any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount (other than an amount referred to in section 8(1), 8B or

8C) received or accrued in respect of any employment or the holding of any office: [...]"

Section 7B states the following:

“7B. Timing of accrual and incurral of variable remuneration

(1) For the purposes of this section –

[...]

“variable remuneration” means –

(a) overtime pay, bonus or commission contemplated in the definition of “remuneration” in paragraph 1 of the Fourth Schedule;

[...]

(2) In determining the taxable income derived by any person during a year of assessment, any amount to which an employee becomes entitled from an employer in respect of variable remuneration is deemed to –

(a) accrue to the employee; and

(b) constitute expenditure incurred by the employer,

on the date during the year of assessment on which the amount is paid to the employee by the employer.”

In *Secretary for Inland Revenue v Silverglen*, Steyn CJ noted that:

“The requirement that receipts as well as accruals must be disclosed, with the provision for a penalty and additional taxation, and the levy of the tax on both receipts and accruals, clearly indicate that Parliament contemplated an assessment of the tax in every year also on accruals during that year; and if that is what Parliament contemplated, I know of no ground on which the Secretary could as of general right postpone the assessment of disclosed accruals to a subsequent tax year when it may be more advantageous to the Treasury to tax them as receipts in respect of that year.” (30 SATC 199 at 208).

Cash payments such as bonuses which are received by the taxpayer, are taxable in the year of assessment in which they are received in terms of paragraph (c) of the definition of “gross income” read with section 7B(2) of the ITA. As such, a clawback provision would only postpone the receipt of the bonus if it is framed as a suspensive condition, i.e. until the clawback period ends, the bonus is not paid to the employee (Silke, 2018: para. 2.11). If this is the case, then it is submitted that such a provision may actually constitute *malus*, as it does not affect any vested rights nor does it require the recovery of payments made to the taxpayer (Madlela, 2018: 46), as payment has not yet been made. In these circumstances, the provision would not affect the ordinary taxing point.

If the clawback provision is framed as a resolutive condition, on the other hand, the bonus could be actually paid to the employee and remain subject to clawback. It is submitted, in this instance, that clawback would not postpone the taxing point, as the bonus would actually be paid to the employee.

4.2. Cash-settled equity instruments

Section 8C(7) (set out above) defines an equity instrument. This section refers to contractual rights and would apply to *inter alia* certain ‘phantom share’ schemes (Silke, 2018: para. 4.73C), where the awards are cash-settled, but they fall under the definition of “equity instrument” in section 8C(7). Insofar as the cash-settled equity instruments are subject to clawback, they will also constitute restricted equity instruments in certain circumstances.

Where the equity-settled section 8C instruments have been disposed of during the vesting period, what are the implications where the taxpayer is, in terms of a clawback provision, required to pay a cash amount equal in value to the shares had the taxpayer retained ownership of the shares? It is submitted that this cash amount would constitute the “financial penalty” referred to in paragraph (b)(ii) of the definition of a “restricted equity instrument” in section 8C(7), rather than the return of the restricted equity instrument itself. A related question is whether the payment of a cash substitute by the taxpayer would constitute a disposal in terms of paragraph 11 of the Eighth Schedule. It is submitted that it would not constitute a disposal in terms of paragraph 11(1)(b) read with paragraph 13(1)(ix) of the Eighth Schedule – there is no change of ownership of the section 8C equity instrument itself, as the asset has already been disposed of to a third party.

The detail regarding the deduction mechanism for taxpayers whose cash or cash-based payments have been clawed back is set out in chapter 6 of this dissertation.

4.3. USA

In the USA, cash-based compensation is not subject to section 83 of the IRC (Melone, 2013: 112) and is taxable in the year of receipt, or when it is constructively received by the taxpayer (Melone, 2010: 96). The taxing point

for bonus deferral arrangements would be postponed where section 409A is applicable (Melone, 2010: 96-97).

Where cash-based compensation must be returned to the employer due to the enforcement of a clawback provision, the tax consequences, and the availability of a section 1341 deduction to the employee, hinge on whether the employee was at fault or not; since, if the employee was at fault, he had no apparent right to the income (Melone, 2010: 98; Melone, 2013: 112). The concept of fault, and the nature of the right to the initial compensation, is material in this regard – if clawback is triggered as a result of a loss in a subsequent year of assessment, rather than a restatement of earnings, the Internal Revenue Service may regard the taxpayer's right to the income as absolute, and therefore the taxpayer cannot claim a section 1341 deduction in the tax year in which it is clawed back (Melone, 2010: 100-102).

4.4. Chapter summary

A cash payment is taxable in the year of assessment in which it is received by the taxpayer, in terms of paragraph (c) of the definition of "gross income" read with section 7B(2). Where a clawback provision applies to that cash amount, it is submitted that where clawback postpones the accrual of an amount it would effectively be a suspensive condition - this may make it a *malus* provision. If it is a resolutive condition that does not preclude the cash amount from being paid or payable, it is submitted that the provision would not affect the taxing point of the bonus. Where the equity-settled section 8C instrument has been disposed of and cash is recovered in lieu thereof, it is submitted that the latter constitutes a financial penalty in terms of paragraph (b)(ii) of the definition of a "restricted equity instrument" in section 8C(7). The payment of a cash substitute will not constitute a disposal in terms of paragraph 11(1)(b) read with paragraph 13(1)(ix) of the Eighth Schedule. The USA only applies a deduction for amounts which have been clawed back from the taxpayer, where these were never truly earned in the first place (Melone, 2010).

4.5. Scenario 1

The 25% portion of the bonus was paid to Robert and there were no other conditions that were imposed that prevented Robert from claiming payment of, and enjoying, the bonus. Thus the clawback provision was a resolutive condition applicable after payment. Therefore, the bonus was taxable in the 2019 year of assessment, when it was received by Robert in terms of section 7B.

If Robert disposed of the shares after the trust had transferred them to him at the end of the vesting period, the company's clawback policy may require him to repay the monetary equivalent of the shares. The taxing point would have arisen on the date that the shares were disposed of in terms of section 8C, but the cash amount thus paid would be the 'financial penalty' referred to in section 8C(7).

4.6. Scenario 2

AccraCorp recovered the shares from Sarah by enforcing a clawback provision. If it had tried to recover the cash amount, on the other hand (due to her disposing of the shares during the clawback period), this would not have affected the taxing point of the shares, as the shares would have been taxed upon disposal. Rather, this would have constituted a 'financial penalty' as referred to in section 8C(7).

5. Chapter 5: the tax implications for employers

This chapter sets out the tax treatment of deductions claimed by employers for cash bonuses and settling section 8C instruments, where these amounts or assets are clawed back by that employer in a subsequent year of assessment. The first section will set out the applicable legislation that has not yet been quoted in this dissertation, followed by a discussion of when an employer may claim a deduction for settling shares to an employee; and how the value included in the employer's income would be calculated in the year of assessment in which those shares are clawed back. Finally, the principles will be summarised and thereafter applied to the two scenarios.

5.1. The current position

“ **“gross income”**, in relation to any year or period of assessment, means –

[...]

(n) any amount which in terms of any other provision of this Act is specifically required to be included in the taxpayer's income and that amount must –

(i) for the purposes of this paragraph be deemed to have been received by or to have accrued to the taxpayer; and

(ii) in the case of any amount required to be included in the taxpayer's income in terms of section 8(4), be deemed to have been received or accrued from a source within the Republic notwithstanding that such amounts may have been recovered or recouped outside the Republic:

Provided that where during any year of assessment a person has become entitled to any amount which is payable on a date or dates falling after the last day of such year, that amount shall be deemed to have accrued to the person during such year;”

The relevant parts of section 8(4)(a) state the following:

“(4)

(a) There shall be included in the taxpayer’s income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive, [...] except section 11(k), 11(n), 11(p) and (q), section 11F, section 12(2) or section 12(2) [...], whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment: [...]”

The section above does not apply in certain circumstances, the latter of which are not relevant to the subject-matter of this dissertation.

Section 11(a) of the ITA states the following:

“11. General deductions allowed in determination of taxable income. – For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

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

Section 23(g) state that:

“no deductions shall in any case be made in respect of the following matters, namely...

- (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.”

Section 23H states the following:

“23H. Limitation of certain deductions

- (1) Where any person has during any year of assessment actually incurred any expenditure (other than expenditure incurred in respect of the acquisition of any trading stock)-
 - (a) which is allowable as a deduction in terms of the provisions of section 11(a) [...]; and
 - (b) in respect of –
 - (i) goods or services, all of which will not be supplied or rendered to such person, during such year of assessment; or,

- (ii) any other benefit, the period to which the expenditure relates extends beyond such year of assessment,

the amount of the expenditure in respect of which a deduction shall be allowable in terms of such section in the said year and any subsequent year of assessment, shall be limited to, in the case of expenditure incurred in respect of-

[...]

- (ii) services to be rendered, an amount which bears to the total amount of such expenditure the same ratio as the number of months in such year during which such services are rendered bears to the total number of months during which such services will be rendered or, where the period during which such services will be rendered is not determinable, such period during which the services are likely to be rendered;

Provided that they fall within the requirements of the general deduction formula set out in sections 11(a) and 23(g), an employer can claim all amounts that it paid to an employee by virtue of a contract of employment as a deduction from its taxable income (Silke, 2018: para. 7.29). This usually includes, *inter alia*, annual bonuses which are paid out by the employer in order to keep their employees sufficiently motivated to contribute to the business' success (Silke, 2018: para. 7.29). Turning to shares, according to the *Labat* case (which in turn, referred to *ITC 1783 66 SATC 373*), it was held that where a company issues a share, "it does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders, and that it can therefore not qualify as an expenditure" (Silke, 2018: para. 13.19; *Commissioner of South African Revenue Service v Labat* (2012) 74 SATC 1

(SCA)). According to *Silke*, the court's rationale should also apply to shares that are issued for employee share plans (*Silke*, 2018: para 13.19).

The provisions set out above, indicate that a tax deduction is available for the cost of settling awards of equity instruments, provided that there was expenditure or economic loss incurred by the employer in order to settle the instruments; and the employer did so in order to incentivise the employee to make a success of the business; and thus the cost was incurred in the production of income. Section 8(4)(a) only applies to recoupments or recovery of amounts by the taxpayer that incurred the expenditure (*Silke*, 2018: para. 4.58; *Commissioner of South African Revenue Service v Wooltru Property Holdings (Pty) Ltd* 70 SATC 223: para. 34). The amount that can be recovered or recouped must be as a result of a legally enforceable right to do so, which the taxpayer is able to enforce during the year of assessment (*Silke*, 2018: para. 4.58).

The deduction claimable is limited by section 23H(b)(ii) to an amount which bears to the total amount of that expenditure the same ratio as the number of months in that year during which the services were rendered bears to the total number of months during which the services will be rendered.

It is submitted that the deduction would also be available for restricted equity instruments, to the extent that actual expenditure has been incurred by the company to settle those instruments. Section 11(a) does not require that the expenditure incurred in respect of remuneration only relate to unrestricted equity instruments.

If the equity instruments, or the monetary equivalent, are clawed back by the company, the section 8(4)(a) rules relating to recoupment of section 11(a) expenditure would apply. Where the company settled the equity instruments by issuing shares, however, there would have been no section 11(a) deduction

(*Labat*, supra); therefore, section 8(4)(a) will not apply if the shares are clawed back in those circumstances.

It is necessary to determine the value that would be included in the employer's gross income in the year of assessment in which the shares are clawed back, if the value of the shares increased or decreased after the expenditure was incurred (and calculated in accordance with section 23H). For example, the shares that were settled may have been purchased off the market at R10 per share. The amount subsequently clawed back may have been reckoned on the date on which the trigger event occurred, and the share price on that date may have been R8. The wording of section 8(4)(a) refers to "all amounts allowed to be deducted or set off under the provisions of sections 11 to 20...", implying that the full R8 may be subsequently included in the employer's gross income. On the other hand, if the shares were worth R12 on the date of the trigger event, then only R10 should be included in the employer's gross income by virtue of section 8(4)(a), as the additional R2 was not incurred as expenditure in terms of section 11(a).

So in this example, how should the R2 arbitrage be treated? In addition, what should the tax treatment be of shares which are clawed back by the employer where no expenditure was incurred, and thus no section 11(a) deduction could be claimed (in terms of *Labat*)? It is unclear what the correct position is. On one hand, the increase in value of the share thus clawed back, or the return of the issued share, could fall within the definition of "gross income" in section 1 of the ITA, and be taxed accordingly. As the share would not constitute capital in the hands of the employee while it remains subject to a section 8C restriction, it is difficult to envisage how the increase or decrease in value would be of a capital nature in the hands of the employer once the instrument is clawed back. It is submitted that the increase in value would fall within the definition of "gross income" as the total amount (i.e. the increase in the value of the share) would effectively be received by the employer (through clawback) in its favour. On the other hand, if the shares decreased in value from the date

that the expenditure was incurred, it is submitted that the employer would only need to include the reduced value of the share in its gross income; the amount by which the expenditure exceeded the value of the share would not need to be included.

If the shares have been sold and the monetary equivalent of the shares is recovered by the employer by virtue of a clawback provision, that monetary equivalent can be considered an amount “recovered or recouped” in terms of section 8(4)(a). It is submitted that where the employer actually incurred expenditure in settling the shares, this monetary equivalent should be accepted as an “amount allowed to be deducted or set off”, and should therefore be included in the employer’s gross income for the year of assessment.

5.2. Chapter summary

An employer can claim a deduction for any amounts that it paid to an employee by virtue of employment from its taxable income, including annual bonuses (Silke, 2018: para 7.29) and shares used for an employee share plan (Silke, 2018: para. 13.19) where an expense was incurred (*Labat, supra*). It is submitted that the costs incurred in settling a restricted equity instrument to an employee would also be deductible. Where an employer claws back the shares and those shares have appreciated in value since the deduction was claimed, only the amount that was claimed as a deduction should be included in the employer’s income in terms of section 8(4)(a).

5.3. Scenario 1

In scenario 1, a portion of Robert’s cash bonus would be clawed back by the company. The full bonus would be deductible, as it was intended to incentivise Robert to pursue SugarCorp’s business performance; it was expenditure

actually incurred by SugarCorp; and it did not amount to expenditure of a capital nature. The R500,000 that would then be clawed back from Robert by SugarCorp would be included in the latter's income in the year of assessment during which it was clawed back, as it met the requirements of section 8(4)(a). As the services rendered were required and measured over a 12 month period, the deduction claimable by SugarCorp in terms of section 23H(b)(ii) in relation to that year of assessment would be the full expenditure incurred.

Regarding the shares, to the extent that the company incurred expenditure in order to settle the section 8C instruments (i.e. through purchasing the shares off the market and transferring them to the SugarCorp Incentive Trust), the expenditure would have been incurred by it in the production of its income. A third of the cost incurred in settling the shares, which was allowed as a section 11(a) deduction, would be included in SugarCorp's income in the year of assessment in which it is clawed back from Robert, as the 12 months during that year of assessment amounts to one third of the full 36 month performance period. If the shares were issued by the company, on the other hand, there would not have been a section 11(a) deduction available to it since no cost was incurred (*Labat, supra*).

The SugarCorp Incentive Trust does not carry on a trade, and thus it does not incur any expenditure in the production of income. Therefore, section 8(4)(a) will not apply if the SugarCorp Incentive Trust claws back the shares. That said, if:

- a) the cash equivalent of the shares is clawed back by SugarCorp itself,
and
- b) the company incurred an expense in acquiring the shares and successfully claimed a deduction for the expenditure,

it could be argued that the cash equivalent that is clawed back should be included in the company's income in terms of section 8(4)(a), in the year of

assessment in which it is clawed back (subject to the rule of proportionality in section 23H(b)(ii)).

5.4. Scenario 2

When AccraCorp acquired shares off the market in order to settle the conditional share awards once they vested (in terms of the plan rules) in Sarah, a corporate tax deduction was claimed, because the shares were settled to Sarah to incentivise her to achieve the company's financial and strategic performance.

Based on section 8(4)(a), a third of the amount which was claimed by AccraCorp as a deduction will be included in its income in the year in which the shares are clawed back, as this is proportionate to the number of months served by Sarah in the year of assessment over the total number of months served during the 3 year performance period. To the extent that the shares appreciated in value (and thus the value that AccraCorp recovered exceeded the amount that was claimed as a deduction), the difference between the amount claimed as a section 11(a) deduction, and the value of the shares on the date on which they are clawed back could be taxable in AccraCorp's hands as revenue. If the value depreciated during that period, AccraCorp could still claim the full expenditure incurred as a section 11(a) deduction. Similarly, if a cash amount is recovered by AccraCorp in lieu of the shares (which Sarah may have disposed of during the clawback period), that amount could be included in AccraCorp's income as a recoupment in terms of section 8(4)(a).

6. Chapter 6: the tax position of employees whose equity instruments are clawed back

Based on the findings set out in the previous chapters, this chapter sets out the tax position of employees whose equity instruments have been successfully clawed back by their employer; in particular, whether they can claim a refund or deduction for the tax paid on the shares or amounts that have been clawed back. The relevant legislation is set out below, followed by a discussion of whether equity instruments would fall within the definition of “amount” in section 11(nA). The comparable USA position will then be set out, followed by a summary of the chapter and thereafter the law will be applied to the two scenarios.

6.1. The current position

Employees who are required to refund remuneration are allowed to claim a tax deduction in terms of the ITA. Section 11(a) was quoted in chapter 5; section 11(nA) is set out below.

“(nA) so much of any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount received or accrued in respect of or by virtue of any employment or the holding of any office as was included in the taxable income of that person and is refunded by that person;”

The relevant portions of section 23 state the following:

“23. Deductions not allowed in determination of taxable income. –
No deductions shall in any case be made in respect of the following matters, namely –

[...]

(m) subject to paragraph (k), an expenditure, loss or allowance, contemplated in section 11, which relates to any employment of, or office held by, any person [...] in respect of which he or she derives any remuneration, as defined in paragraph 1 of the Fourth Schedule, other than –

[...]

(iiA) any deduction which is allowable under section 11(nA) or (nB);”

6.2. Meaning of the word “amount” in sections 11(nA) and 23(m)(iiA)

It is necessary to determine the meaning of the word “amount” in these sections and whether this includes section 8C instruments. According to case law, an “amount” for tax purposes would include money and the value of any form of property, whether corporeal or incorporeal (*WH Lategan v Commissioner for Inland Revenue* 2 SATC 16 at 19; *Commissioner for Inland Revenue v People Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A)). However, SARS is of the view that “amount” in the context of section 11(nA) only refers to cash, relying on the definitions of “refund” in various English dictionaries (as the word is not defined in the ITA) (SARS, 2016: 2; 3-4). Section 11(nA) also requires that an amount be included in gross income, so it must have either accrued to or been received by the taxpayer (SARS, 2016: 2-3). The amount had to have been received as consideration for services rendered, or by virtue of the taxpayer’s employment or office held (SARS, 2016: 3). The amount had to constitute taxable income in the year of assessment (i.e. not subject to any exemptions) (SARS, 2016: 3). The amount that would have been included in taxable income would have been the gross remuneration before tax, and the deduction is limited to the amount stipulated in the employment contract (SARS, 2016: 4). The taxpayer must prove (via documentary proof) to SARS that the remuneration was included in his or her taxable income and then refunded (SARS, 2016: 6).

It is submitted that SARS' interpretation of the ambit of section 11(nA) is plausible but has potentially onerous consequences if clawback is implemented. A restricted equity instrument would not be included in the employee's taxable income. However, as stated previously, until there is clear guidance on the intersection of section 8C and clawback, some companies may take a pragmatic approach and withhold employees' tax in terms of the Fourth Schedule from restricted equity instruments which have vested for legal purposes. Section 11(nA) itself does not refer to "remuneration" – rather, it refers to "amounts", which can be narrowly interpreted (as SARS has seen fit to do), even though the definition of "remuneration" in the Fourth Schedule includes cash and other forms of property given to employees as consideration for their services rendered (Fourth Schedule, ITA: paragraph 1).

This means that restricted equity instruments, the value of which would have been included in the employee's taxable income by the employer, would not be deductible by the employee under section 11(nA) in the event that they are clawed back. This approach creates significant hardship for taxpayers whose equity instruments are clawed back. A related enquiry is whether SARS would allow the employee to reopen their assessments for the year of assessment in which the equity instrument was taxed, in order to remove the equity instrument from taxable income, which the taxpayer could argue was not actually earned. The plausibility of this alternative argument is dealt with in more detail in chapter 7.

If section 11(nA) does not apply to the recovery of equity-settled 8C instruments by the company, it is submitted that in these circumstances, the taxpayer cannot seek to rely on the general deduction formula in section 11(a) to justify a tax deduction, by virtue of section 23(m). The expenditure or loss would relate to employment or office held, in respect of which the employee derived remuneration that was taxed in terms of section 8C. Paragraph 1 of the Fourth Schedule defines "remuneration" as follows:

“ **remuneration**” means any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered, including –

[...]

(e) any amount referred to in section 8C which is required to be included in the income of that person;”

Cash-based amounts would in all likelihood fall within the definition of “amount” as described by SARS; it is submitted that a cash bonus that has been clawed back, as well as a cash amount that is clawed back in lieu of an equity instrument would be deductible in terms of section 11(nA).

Following SARS’ interpretation, what of the equity instruments that are held for 3 years or more, where the proceeds of their disposal are treated as capital gains in terms of section 9C (provided that all other requirements are met)? Such equity instruments would, by necessity, be free of clawback provisions in order for them to have vested for section 8C purposes. However, if employers take a pragmatic approach and deduct Employees’ Tax for the value of the restricted equity instruments in the year in which they legally vest, the employee will encounter the same problem set out above – they cannot (based on SARS’ interpretation) claim a section 11(nA) deduction if clawback is implemented on equity-settled instruments.

If the word “amount” in section 11(nA) was to be interpreted widely to include equity instruments (which would be included in the definition of “gross income”), the related question is when the market value of those instruments should be taken into account for determining the “amount” in section 11(nA) – is it the date on which the instrument is returned to the employer, or at the end of the year of assessment? Or is it the difference between the market value of the asset on the vesting date, and the consideration (if any) paid for the acquisition of the equity instrument in terms of section 8C? The third option would not be available where there was no section 8C taxing point, as the instruments remained restricted until clawback is enforced by the company. It is submitted that the deduction available would be limited to the amount initially included in the taxpayer’s income, which would be taken into account for the purposes of section 11(nA).

Amounts received by the taxpayer in respect of a restricted equity instrument are treated as income in terms of section 8C(1A). If these amounts are clawed back by the company in a subsequent year of assessment, it is submitted that the taxpayer can claim a section 11(nA) deduction for these amounts, provided that they meet the other requirements in that section.

6.3. USA

In the USA, taxpayers cannot amend their original tax returns to exclude the compensation paid to them in that year, where this is clawed back by the employer, due to the operation of the annual accounting concept (Melone, 2013: 74).

Where a company claws back capital gains from an employee, the employee can claim a capital loss for that repayment, subject to certain conditions (Melone, 2010: 87). While taxpayers can easily claim deductions for the repayment of compensation by virtue of section 1341, the resulting tax benefit

will not be commensurate with the tax benefit that would have been obtained if the compensation had not been initially included in the taxpayer's initial taxable income (Melone, 2010: 90; Melone, 2013: 74).

6.4. Chapter summary

Employees who are required to refund remuneration may claim a concomitant tax deduction in terms of section 11(nA) of the ITA. According to section 23(m)(iiA), a deduction under section 11(nA) is allowable in the determination of taxable income. SARS has taken the view that the reference to "amounts" in section 11(nA) will only apply to monetary payments. It is submitted that the refund of a cash amount or bonus would be included in the definition of section 11(nA). If employers choose to take a pragmatic approach and withhold Employees' Tax from the shares when they vest in terms of the constitutive plan rules, which are thereafter clawed back, SARS' view would be that the employee cannot claim a section 11(nA) deduction; however if "amounts" is interpreted to include equity, the deduction should be claimable. Turning to the USA, Melone (Melone, 2010: 90, 94) takes the view that taxpayers can claim deductions for the repayment of compensation, but the tax benefit of doing so will not be the same as if the compensation had not been included in the employee's remuneration in the first place.

6.5. Scenario 1

Based on section 23(m)(iiA), read with section 11(nA), Robert would be able to claim a deduction equal to the R500,000 bonus that was clawed back by SugarCorp, in the year of assessment in which it was clawed back.

For the shares acquired by Robert once he exercised the SAR, on the other hand, if he is compelled to return the shares to SugarCorp (and SugarCorp withheld Employees' Tax), based on a narrow interpretation of section 11(nA),

he cannot claim a tax deduction for the value of the equity instruments that he forfeited. On a broader interpretation, it is submitted that Robert could claim the deduction, equal to the amount which was initially included in his taxable income in the relevant year of assessment.

If, however, the amount clawed back is a cash-based substitute for the equity shares, then Robert would be able to claim a deduction equal to the amount which was initially included in his taxable income in terms of section 11(nA).

6.6. Scenario 2

For the conditional shares which were clawed back by AccraCorp, based on SARS' narrow interpretation of sections 11(nA) and 23(m), the value of the equity instruments that were clawed back may not be deductible by Sarah, although the cash equivalent will be deductible in terms of that section. On a broader interpretation of the word "amount" in terms of section 11(nA), however, Sarah can claim a deduction for the value of the shares which were clawed back in that year of assessment.

7. Chapter 7: discussion of possible legislative amendments

This chapter sets out the unintended tax consequences that may arise from the interpretation of the provisions of the ITA to clawback, based on the conclusions in the previous chapters. The unintended consequences are summarised below, which include the capital nature of restricted equity instruments; the timing of the disposal of equity instruments; the interpretation of the word “amounts” in section 11(nA) and section 23(m); the legal nature of clawback; and then the definition of a restricted equity instrument in section 8C. The last segment of the chapter addresses whether it is necessary to amend section 8C to cater for clawback and contains high-level suggestions of what that amendment should entail. This will be followed by a brief summary.

7.1. A summary of the unintended consequences

The fact that there is no concrete precedent for the tax and legal treatment of clawback in SA exacerbate the unintended consequences of the ITA and paragraphs of the Eighth Schedule in this context. Without fully grappling with the legal nature of a clawback clause, which in turn will depend on the intention of the parties, it is difficult to determine how sections of the ITA and paragraphs of the Eighth Schedule will apply in practice.

7.1.1. Capital nature of restricted equity instruments

From a tax law perspective, the capital nature of restricted equity instruments which are subject to clawback should be explored in greater depth. Firstly, based on the interpretation that this dissertation has taken of sections 8C and 9C respectively, any gain or loss arising from the disposal of an equity instrument can only be treated as capital once the equity instrument is no longer subject to section 8C. This can give rise to an anomalous situation where a capital gain or loss (should it arise) is not taxed as such in the

taxpayer's hands even though full transfer of legal ownership of the shares has occurred from the employer or trust to the taxpayer, because the shares are still restricted equity instruments.

As stated in paragraph 11(1)(b) of the Eighth Schedule, a disposal also includes the forfeiture, surrender or relinquishment of an asset. As discussed, it is possible that the refund of shares constitutes a forfeiture or disposal in terms of the Eighth Schedule; however, this dissertation has also asserted that while an equity instrument remains restricted during the clawback period, it is not a capital asset in terms of section 9C. Therefore, any forfeiture of those shares would not constitute a CGT event for purposes of the Eighth Schedule. For the section 9C and (by extension) paragraph 11(1)(b) implications, it is submitted that the ambiguity in their application can be partially remedied by amending section 8C.

7.1.2. Eighth Schedule – paragraph 13

A further ambiguity is that the timing of the disposal of equity instruments, where a clawback provision is in place, is unclear. The time of disposal of an asset which is not specifically included in paragraph 13(1) of the Eighth Schedule is the date of change of ownership. For conditional shares, the change of legal ownership from employer to employee can occur while the clawback provision remains in place (indeed, this is the point of clawback as it acts as a recovery mechanism after ownership has been transferred (Madlela, 2018)). The employee is free to dispose of the share to third parties, but it is still at risk of forfeiture (albeit the employee will return a cash substitute to the employer, rather than the original shares). If section 9C does not deem capital gains and expenditure incurred for instruments that have not yet vested for section 8C purposes, but a change of legal ownership can occur for restricted equity instruments, the two provisions of the ITA appear to be in conflict (as far as clawback and section 8C are concerned). Furthermore, it is submitted that the imposition of clawback does not create an asset in the hands of the

employer in the same way that a restraint of trade would, but whether there is another ground for the creation of an asset should be explored in a separate dissertation or article.

Equity instruments that are administered through a trust are specifically mentioned in paragraph 13, and the timing of the disposal will be the date on which the equity instruments vest in the employee. The position is unclear where section 8C vesting occurs when the clawback period ends, even though the clawback provision does not preclude the trust from vesting those shares in the employees once the legal vesting conditions have been satisfied. This could lead to yet another anomalous situation – the equity instruments legally vest in the employee, yet they remain restricted. The gains and losses in respect of that instrument are still subject to paragraph 64E, but they are not treated as capital in terms of section 9C during the clawback period.

Paragraph 64E also allows the trust to disregard capital gains in respect of an equity instrument insofar as they will be included in the taxable income of the employee for section 8C purposes. However, if the trust releases the restricted equity instruments to the employee after the initial legal vesting period but during the clawback period, paragraph 64E would continue to apply. However, if the employee disposes of the section 8C asset and vesting is deemed to have occurred in terms of section 8C(3)(b)(ii), the trust can disregard the capital gain in accordance with paragraph 64E (as the gains will be included in the employee's taxable income). The section 9C implications have been outlined above. This is a *lacuna* in the law which (it is submitted) can be remedied by clarifying how clawback will influence the vesting date in terms of section 8C.

7.1.3. Section 11(nA) only applying to cash amounts

According to SARS' interpretation, section 11(nA), read with section 23(m), precludes an employee from claiming a deduction for remuneration that is

recovered by the employer, if it does not constitute a monetary “amount” (SARS, 2016: 2; 3-4). This would preclude the taxpayer from claiming a deduction after the refund of equity instruments (i.e. share-based payments), where an employer withholds Employees’ Tax in the year of legal vesting. This would leave the employee in a negative tax position. Furthermore, an argument could only be made to reopen assessments in the year in which the amount was taxed if a taxpayer successfully proved that the amount was not truly earned. Some see clawback as enabling the recovery of erroneously paid compensation (Madlela, 2018: 45). It is also understood that tax is not preoccupied with considerations of equity:

“The mere existence of hardship or inequity resulting from the application of the plain provisions of fiscal legislation is beside the point. Hardship and inequity are not to be used for the purpose of reading into plain terms a meaning which they do not otherwise bear...” (*Badenhorst & Others v Commissioner for Inlands Revenue* 20 SATC 39 at 49).

That said, this interpretation of the legislation may lead to unintended consequences, and it does not mean that the legislature should not intervene in order to ensure that the fiscus does not unduly benefit if a clawback provision is enforced. Although this will require greater investigation, it may be worth expressly including, in section 11(nA), a reference to amounts in the definition of “remuneration” as contained in the Fourth Schedule. This can be accomplished by amending the legislation, or revising the SARS interpretation note to include a wider interpretation of the word “amount” (SARS, 2016).

A similar difficulty is encountered in the interpretation of section 8(4)(a), which also only applies to “amounts”. Although the SARS interpretation note (SARS, 2016) on section 11(nA) does not expressly deal with section 8(4)(a), SARS may choose to take the same approach to defining “amounts” in section 8(4)(a). However, this may not necessarily lead to an inequitable result; even if the value of the equity instrument is claimed as a deduction in terms of

section 11(a), but is not subsequently included in the company's income by virtue of section 8(4)(a), the refunded shares may still be treated as a receipt or accrual in terms of the definition of "gross income" in section 1.

A further issue with section 8(4)(a) and the application to restricted equity instruments that are clawed back arises when the value of the shares clawed back exceeds the cost of settlement, due to an increase in the share price (and the converse applies where there is a subsequent reduction of the share price). The difference between those two amounts may be a capital gain or loss (as the case may be), but the instruments were never treated as capital as section 9C did not apply during the clawback period. The uncertainty may be remedied by amending section 8C (outlined below).

7.1.4. Legal nature of clawback needs to be clarified

As mentioned in chapter 3, it is essential to properly define the legal nature of a clawback clause. This dissertation has treated it as a contractual clause, but other scholars should assess whether the law of delict has an impact on the legal implications of clawback; and whether the rise of a trigger event results in a breach of contract. The ITA does not appear to draw a firm distinction between apparent, absolute and non-existent rights to income, whereas the USA IRC does draw this distinction when dealing with the availability of a tax deduction (Melone, 2010). USA tax legislation is obviously different to SA law, however it is worth considering whether a distinction should be drawn between fault and no-fault trigger events in the context of clawback. As examples, no-fault trigger events could include material misstatements of financial results through no fault of the taxpayer; and fault-based trigger events could include gross misconduct.

It could be argued that where a no-fault trigger event occurs, the enforcement of the clawback provision itself could indeed amount to restitution *in integrum* (as the intention to claw back the shares may not be punitive), and return the

parties to the position that they would have been in had the contract never been entered into (*LAWSA*, 2014: para. 363) – this would depend on whether the employer is also prepared to return any consideration given to it (or a suitable substitute) by the employee. On the other hand, a fault-based trigger event may be treated differently, as the employer may not be compelled to return the employee to the position that he or she was in before (and otherwise compensate him or her for services rendered) – this would defeat the point of clawback. There are also practical issues associated with this approach, i.e. imperfectly drafted clawback provisions which do not clearly distinguish between fault and no-fault trigger events. The ongoing legal uncertainty around the nature of clawback and its consequences should be considered carefully if the ITA is amended. This should be considered in a separate dissertation or article.

It is also worth investigating the section 8C implications where a company is able to pursue an errant executive for pecuniary loss for a breach of common law and statutory law duties; these are not limited to recovering section 8C instruments, nor are they subject to a predetermined clawback provision. In particular, a separate article or dissertation should consider whether these could give rise to section 8C restrictions.

7.1.5. Section 8C of the ITA – definition of ‘restricted equity instrument’

It may be necessary to amend the definition of a restricted equity instrument to explicitly exclude clawback provisions from the description of “financial penalty”. In turn, clawback would need to be properly defined in section 8C, in order to avoid ambiguity and misapplication of the amendment. It is submitted that amending section 8C would be far less disruptive than attempting to amend multiple provisions of the ITA and the Eighth Schedule to address clawback, as many of these clauses refer directly to the vesting date in terms of section 8C. The potential impact of doing so is outlined below.

- 1) Equity instruments that are subject to clawback would no longer be considered “restricted equity instruments”, thus avoiding artificially prolonging the tax vesting period (perhaps unintentionally) long after the legal vesting period has come to an end. It would also remove the ambiguity around whether or not the taxing point would arise on the date that the clawback provision is actually exercised, or the date that the provision is successfully enforced (after all, if the claim fails in the courts, the company cannot exercise the provision over those equity instruments again). The current interpretation of “financial penalty” in the instance of clawback does not deal with instances where, after the legal vesting period has come to an end, the equity instrument can be freely disposed of by the taxpayer during the subsequent clawback period.
- 2) The CGT implications of shares which are clawed back would also be simplified. The date of disposal for CGT purposes would be the date that ownership is transferred, which would coincide with the section 9C deeming provisions (provided that the instruments have been held for at least 3 years) (SARS, 2019: 43). Paragraph 64E of the Eighth Schedule would not continue to apply in instances where the trust distributes the shares to the employee but they remain subject to clawback, as clawback would no longer constitute a restriction for section 8C purposes.
- 3) The uncertainties associated with clawback provisions which apply indefinitely would be ameliorated and vesting for section 8C purposes would not be postponed for an indefinite period.

As an alternative, one could expand the deemed disposals in section 8C(3)(b) to include instances where the restricted equity instruments have become tradable by the employee. This would at least ensure that, where the employee can dispose of the shares freely at market value, the clawback provision in respect of those instruments does not further delay the taxing point for section 8C purposes.

The issue with the proposed solutions set out above is that clawback provisions are not standardised in SA. Therefore, the express exclusion of clawback may be so broad that it creates unintended consequences (i.e. it may cover shares recovered by the company through the use of Companies Act remedies (Companies Act, Act 71 of 2008: section 76)), or so narrow that it excludes different permutations of clawback. The definition of clawback, therefore, should be carefully worded in order to avoid these pitfalls.

An alternative remedy for clawback provisions which apply indefinitely after the vesting date could be to add an additional subsection to the existing deeming provision as suggested (in terms of section 8C(3)), which deems vesting to occur on the legal vesting date if clawback is the only remaining restriction (and the instruments are otherwise freely tradeable). It would also give effect to the anti-avoidance that section 8C is meant to achieve (Silke, 2018: para. 4.73C) – if companies begin to realise that clawback provisions postpone vesting for section 8C purposes, they may purposefully introduce a clause of indefinite duration to make the instruments non-taxable until the date of disposal (which may be years after the legal vesting period has come to an end).

7.2. Chapter summary

Without clarifying the legal nature of a clawback clause, it is difficult to determine how sections of the ITA and paragraphs of the Eighth Schedule will actually apply in the scenarios set out in the previous chapters. It is submitted that the ambiguity associated with the application of paragraphs 11(1)(b) and 64E of the Eighth Schedule to restricted equity instruments can be remedied by amending section 8C to clearly define ‘clawback’ and explicitly exclude clawback provisions from the definition of a ‘financial penalty’ in section 8C(7). The timing of a disposal of an equity instrument, where a clawback provision is in place, is unclear – legal ownership may be transferred, but section 9C will

preclude it being treated as a capital instrument. The narrow interpretation of “amount” in section 11(nA) of the ITA could be remedied by referring to “amounts” as defined in the Fourth Schedule of the ITA. The tax treatment of the difference between an amount that is clawed back and the value of the equity instruments that were taxed could be remedied by amending section 8C. The legal nature of clawback, particularly whether fault and no-fault trigger events should be differentiated (and the tax implications associated therewith), and the section 8C implications of common and statutory law remedies, should be explored in a separate dissertation or article. Amending section 8C(3) to incorporate instruments which are subject to clawback provisions after legal vesting may give effect to the anti-avoidance mechanism of section 8C.

8. Chapter 8: summary and conclusion

The key conclusions reached in this dissertation are summarised below. There are certain areas that are beyond the scope of this dissertation to resolve. It is clear that clawback has a myriad of tax consequences for the employer and employee respectively, which extend far beyond section 8C itself. The chapter will outline the section 8C implications, and their corresponding impact on CGT, cash-based payments, tax deductions available to employers and employees respectively after clawback has occurred, and the legal implications. After summarising the key findings in this chapter, the paper will end with some concluding remarks.

8.1. Section 8C

The presence of a clawback provision that prevents the taxpayer from freely disposing of the equity instrument (per paragraph (a) of the definition of a “restricted equity instrument” in section 8C(7)) would constitute a section 8C restriction. Where the clawback provision does not impose a restriction on disposal, it will still constitute a restriction for section 8C purposes, as the operation of the clawback provision could result in forfeiture of ownership of that equity instrument for an amount “otherwise than at market value”, even after ownership of the equity instruments has been transferred from the employer to the employee. If the clawback provision still applies after the legal vesting date, the share will remain restricted for section 8C purposes (including for clawback clauses that apply indefinitely), unless the shares are disposed of during that clawback period (in terms of section 8C(3)(b)(ii)).

Since a return of capital on a restricted equity instrument is treated as income in the hands of an employee for section 8C(1A) purposes, the employee should be able to claim a section 11(nA) deduction if the instrument (and return on capital) is clawed back.

It has been submitted that amending the definition of a “restricted equity instrument” in section 8C, particularly the definition of a financial penalty, to specifically exclude clawback (which, in turn, would need to be carefully defined) may be a possible solution. The confusion surrounding section 8C, despite a well-intended amendment, could continue to apply to poorly drafted clawback policies. Amending the deeming provisions in section 8C(3)(b) to include instances where the employee can freely trade with the equity instruments may be another possible solution.

8.2. CGT

Section 9C will only apply to gains or losses arising from disposals of equity instruments that are held for at least 3 years by the taxpayer, and according to SARS’ interpretation, are unrestricted at the time of their disposal (SARS, 2018a: 11).

The application of paragraph 64E of the Eighth Schedule that applies to gains and losses in employee share scheme trusts is more complex when clawback provisions are taken into account. It is unclear whether the gains and losses in respect of the equity instrument will continue to be disregarded by the trust after it transfers legal ownership of the shares to the beneficiaries; but the shares are still subject to clawback and the section 8C vesting event does not occur. The gain or loss may be recognised by the trust if clawback is implemented (as the trust cannot disregard it); unless the shares are disposed of by the employee, in which case, vesting is deemed to occur in terms of section 8C(3). It is submitted that the ambiguity can be remedied by amending section 8C.

The base cost of equity instruments in terms of paragraph 20 of the Eighth Schedule will be determined when the clawback period ends with reference to

the market value of the instrument, either on the date that the restriction is lifted (i.e. the clawback period ends), or the date on which the taxpayer disposes of the assets, whichever occurs first. Where the clawback period continues indefinitely, the equity instruments will never be treated as capital assets (and section 9C will not apply) until the date of their disposal, which is anomalous if legal ownership has been transferred. This dissertation also concluded that restraints of trade are not analogous to clawback provisions.

The employee cannot claim a capital loss in terms of paragraph 4 of the Eighth Schedule if clawback is implemented, since (a) the company may not be recovering the proceeds of the disposal from the employee as contemplated in paragraph 4; and (b) the proceeds would not be repayable to the person who paid the proceeds, but to the employer instead.

The precise timing of the disposal is unclear – section 8C vesting of equity instruments is not specifically addressed in paragraph 13 of the Eighth Schedule. However, paragraph 13(1)(a)(ix) recognises that, unless otherwise listed in paragraph 13(1), a disposal event occurs when ownership of an asset is transferred between parties. This would result in the anomalous situation where ownership of a restricted equity instrument is transferred from employer to employee, but the instrument remains restricted for the duration of the clawback period. It has been submitted that the successful enforcement of the trigger event during the clawback period would not give rise to a disposal in terms of paragraph 11 of the Eighth Schedule, as the equity instrument remained restricted. Again, it has also been submitted that the amendment of section 8C (as suggested above) may help remove the ambiguity around the timing of the disposal.

8.3. Cash-based payments

Cash payments such as bonuses are taxable in the year of assessment in which they are received in terms of the definition of “gross income” (ITA: section 1) and section 7B(2). The clawback provision will not postpone the taxing point, unless it acts as a suspensive condition that precludes the cash bonus from being paid to the employee (in which case it will constitute *malus*).

On the other hand, cash-settled restricted equity instruments (in terms of the definition of “equity instrument” in section 8C(7)) are treated in the same manner as share-settled instruments for tax purposes, including the application of clawback. It is also submitted that the cash amount repayable by the taxpayer in lieu of shares which have been disposed of (and thus already taxed) amounts to the “financial penalty” referred to in section 8C(7). The repayment of a cash substitute would not constitute a disposal in terms of paragraphs 11(1)(b) and 13(1)(ix) read together.

8.4. Tax deductions - section 8(4)(a)

Where the section 8C instrument is settled by the company by issuing shares, the company has not incurred an expense and therefore cannot claim a deduction in respect of those shares (*Labat (supra)*). Where an expense has been incurred in the production of income, however, the employer can claim a concomitant deduction in terms of section 11(a) of the ITA. By virtue of section 8(4)(a) read with section 23H(b)(ii) the value of the equity instrument which was clawed back, which was previously allowed as a deduction against the employer’s income, will be taken into account in the year in which it is clawed back, but the deduction in the year of assessment will be calculated in proportion to the number of months in the year during which the services were rendered over to the total number of months during which the services will be rendered. It is also submitted that where a cash equivalent is clawed back by the company, the monetary amount will be included in the employer’s income as a recoupment in terms of section 8(4)(a). That said, the ambiguities around

the interpretation of “amount” in section 11(nA) may apply equally to this provision.

8.5. Employees whose equity instruments are clawed back - section 11(nA)

Employees whose cash and cash-settled equity instruments have been clawed back by the company can claim a deduction in terms of section 11(nA) for the amount that was included in their taxable income. Whether equity-settled awards can also be clawed back will turn on the definition of “amount” in section 11(nA) – SARS asserts (SARS, 2016) that “amount” in that section only refers to the refund of cash-based amounts. If this view is accepted, it would leave taxpayers with no method of recovering the tax paid in respect of those equity instruments. This is a *lacuna* in the law which should be resolved by the legislature, or SARS’ interpretation should be challenged. A broader interpretation of the word “amount” to include equity instruments is possible (if reference is made to the definition of “remuneration” in the Fourth Schedule), and it is submitted that the value of those equity instruments that can be claimed as a deduction will be determined with reference to their market value on the date on which they are returned to the employer.

8.6. Legal implications

It is submitted that a clawback provision would not be a resolutive condition, insofar as the employer is not required to restore the employee to the position that they would have been in had they never entered into the contract (in terms of which the equity instruments were initially acquired) (*LAWSA 2014: para. 358*). Where the trigger event amounts to a condition that the employee can control (for example, gross misconduct), the trigger event could result in a breach of contract. Where the trigger event includes an event that was beyond the control of the employee (e.g. the misstatement of financial results which

were not attributable to the employee), an argument could be made that the clawback effectively amounts to a rescission and restitution of contract, but this only holds if the employer is also required to return the performance tendered by the employee (*LAWSA*, 2014: para. 358). This should be explored in greater depth in a separate piece of work; as stated previously, the legal nature of clawback will have a significant effect on the tax implications thereof.

8.7. Chapter summary

Where a clawback provision prevents a taxpayer from disposing of an equity instrument at market value, this constitutes a restriction as defined in section 8C(7), as this could lead to the forfeiture of ownership of the instrument for an amount less than market value. The restriction will continue until disposal of the equity instrument or the end of the clawback period, whichever occurs first. Amending section 8C to exclude clawback from the definition of a 'financial penalty' may be a way of managing the unintended consequences of clawback, although there will still be challenges. The 8C instrument will only be treated as a capital instrument once it becomes unrestricted (based on an interpretation of section 9C). Following this interpretation, paragraph 64E may result in the capital gains or losses of a section 8C instrument being counted in the hands of an employee share scheme trust after legal vesting, unless there is a disposal by the employee. The base cost of equity instruments will only be determined when the clawback period ends, which may lead to anomalous results where the clawback period continues indefinitely (i.e. until disposal); and successfully enforcing a trigger event during the clawback period would not give rise to a disposal in terms of paragraph 11. Cash bonuses are taxable in the year in which they are paid; unless it is a suspensive condition, a clawback provision would not impact the taxing point. The section 8C implications of clawback will also apply to cash-settled restricted equity instruments, but the repayment of cash in lieu of shares disposed of will be a financial penalty as defined. Where an employer claws back shares or an amount for which it previously claimed a deduction, it will need to include it in

its gross income on a proportionate basis (ITA: section 8(4)(a), section 23H(b)(ii)). Employees can claim a section 11(nA) deduction where an amount is clawed back (where the employer withheld Employees' Tax), but where actual shares are clawed back, the difference in market value may be treated as a capital gain or loss. The legal nature of clawback should be assessed separately, as the tax implications turn on this.

8.8. Concluding remarks

Clawback as a risk adjustment mechanism is on the rise in the SA market (PwC, 2018). The South African Institute of Tax Professionals have reportedly made a submission to the National Treasury and SARS, arguing that clawback provisions amount to a technical restriction for income tax purposes (Visser, 2018). They also assert that where a clawback provision is in effect, an executive can be taxed on shares for their value, even after their sale by the executive concerned (Visser, 2018). Hopefully this submission will encourage the National Treasury to properly consider the tax implications of clawback, before it has to be enforced in SA; and resolve the current confusion around the tax implications of this risk adjustment mechanism.

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