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# CORPORATE & COMMERCIAL ALERT

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ISSUE

## SHARED WISDOM FOR EMPLOYEE SHARE SCHEMES

Most businesses would agree that their most important and most valuable assets are the people that comprise the organisation. In order to retain the best people and to align the interests of employees, employers and shareholders, companies may wish to incentivise key individuals to stay for the “long haul” or to reward employees for the fruits of their hard work by implementing a share incentive scheme.

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# SHARED WISDOM FOR EMPLOYEE SHARE SCHEMES

*Recent developments in South Africa relating to the adoption of certain 'say on pay' measures create an impression that South Africa's regulation of the determination of executive remuneration is stringent.*

*Depending on the purpose of the scheme, if possible, employers should try to structure the scheme in such a way that it is the most tax effective for the Participants.*



**Most businesses would agree that their most important and most valuable assets are the people that comprise the organisation. In order to retain the best people and to align the interests of employees, employers and shareholders, companies may wish to incentivise key individuals to stay for the "long haul" or to reward employees for the fruits of their hard work by implementing a share incentive scheme.**

However, there are a few factors that should be kept in mind in order to ensure that the arrangement is effective and achieves its stated purpose.

#### **Keep it simple**

In many instances, schemes are put in place which are very complicated and difficult to administer.

When drafting the rules of the scheme, employers should ask themselves whether they are prepared to keep up to date records and comply with the legal, regulatory and formal requirements for a share scheme.

Often, schemes use a trust-based structure where shares in the employer company (Company) are issued or sold to a trust and the trust issues units to the employees who participate in the scheme (Participants). A trust must be administered separately to the company with its own bank account and set of financials. Trustees need to authorise all decisions of the trust by resolution.

In many smaller businesses and start-ups that do not have a dedicated company secretary, this could result in a large administrative burden. Thus, if employers who do not like too much paperwork should keep the scheme as simple as possible.

#### **Tax considerations**

Put simply, scheme shares or units (Shares) issued to a Participant at a discount, or Shares which vest over time or "lock in" employees, will usually fall under s8C of the Income Tax Act, No 58 of 1962 (ITA) because the Shares are received by virtue of the Participant's employment. In terms of s8C of the ITA, such Shares will be seen as "restricted equity instruments".

Ordinarily, gains on the disposal of shares held as an investment would be subject to capital gains tax. However, in terms of s8C of the ITA, when the Shares become unrestricted and "vest" or the Participant realises the Shares, any gains will be deemed remuneration and taxed as income in the hands of the Participant at his or her marginal income tax rate. This is a risk that needs to be explained to the employee.

Another tax consideration is that if the scheme shares are subject to s8C of the ITA, the Company will have an obligation to withhold employees' tax (PAYE). The Company may need to apply to SARS for a directive on how much PAYE to withhold.

Depending on the purpose of the scheme, if possible, employers should try to structure the scheme in such a way that it is the most tax effective for the Participants.

# SHARED WISDOM FOR EMPLOYEE SHARE SCHEMES

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*Even if the Participant were to sell some Shares to fund the tax, in the context of a private company, there may be no ready market for the Shares.*



## Liquidity

The liquidity of the Shares could become an issue in the event that the Participant is entitled to realise the value of his or her scheme Shares.

There are a number of ways that this can be achieved, including allowing the Participant to sell to a third party, paying the Participant the value of his or her Shares or the Company buying back the Shares. It is also possible to delay vesting until there is a "liquidity event" such as a takeover or initial public offering.

Realisation of Shares can have cash flow implications for both the Participant and the Company. As set out above, upon vesting the Participant may become liable to pay income tax. This would be the case even if the Shares vest in the Participant and the Participant does not sell the Shares or receives any proceeds. This could result in a large tax bill that the Participant would have to fund without necessarily having cash available.

Even if the Participant were to sell some Shares to fund the tax, in the context of a private company, there may be no ready market for the Shares.

In these instances, careful planning is required to ensure that vesting and realisation are aligned with a liquidity event.

Similarly, if Participants are entitled to realise the value of their Shares by requiring the Company to buy back their Shares or to redeem them for a cash amount, the Company may also be placed in a position where it does not have available cash to fund the payment. In such cases, the Company could consider settling the payment in tranches over time.

Scheme rules should provide for flexibility so that employers have options available to ease the burden on cash resources.

## Regulatory

Under s97 of the Companies Act, No 71 of 2008 (Companies Act) a scheme will qualify as an employee share incentive scheme if the scheme meets the requirements set out in that section. A qualifying scheme will be exempt from certain obligations under the Companies Act, including exemptions relating to financial assistance and public offerings.



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*In the case of a Company whose shares are listed on the JSE, the scheme will need to comply with schedule 14 of the JSE Listings Requirements and be approved by the JSE.*

Briefly, these rules apply to schemes where the Company issues shares or options to employees. To qualify, the rules of the scheme must be registered with the Companies and Intellectual Property Commission (CIPC) and a compliance officer must be appointed. The compliance officer will have reporting obligations to the CIPC.

In the case of a Company whose shares are listed on the JSE, the scheme will need to comply with schedule 14 of the JSE Listings Requirements and be approved by the JSE.

If a Company extends loans to the Participants in order to acquire the Shares, the Company should seek advice as to whether the National Credit Act, No 35 of 2005 is applicable to the arrangement.

#### Conclusion

Employee share schemes are an excellent way to align the interests and vision of employers and shareholders with that of management and key personnel as well as to reward employees by enabling them to share in the growth of the company. If the above considerations are borne in mind, employers should be able to find an effective structure for the scheme.

*Ben Strauss and Clara Hofmeyr*

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