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TAX & EXCHANGE CONTROL **ALERT**

IN THIS **ISSUE**

The end of share incentive schemes?

On 15 October 2021, in *Commissioner for the South African Revenue Service v Spur Group (Pty) Ltd* (Case no 320/20) [2021] ZASCA 145 (15 October 2021), the Supreme Court of Appeal (SCA) handed down judgment on whether a capital contribution made by an employer taxpayer to a trust established for purposes of an employee share incentive scheme was deductible for income tax purposes. The SCA also determined whether prescription applied in the circumstances. This article discusses the case and the impact of its findings on share incentive schemes in South Africa.

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The end of share incentive schemes?

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Context

Employee share incentive schemes are, among other things, designed to align shareholder and employee interests and, therefore, incentivise employees to contribute more meaningfully to the success and growth of the business with a focus on performing in the interests of the business over the long term. It is a long-accepted manner of remuneration and compensation of employees and holders of office in a company.

Importantly, from a tax perspective, it is generally accepted from a policy point of view that remuneration derived by employees from these types of schemes are taxed in the hands of employees as normal income (i.e. akin to salaries). In other words, it is often commercially beneficial to compensate employees by way of awarding them shares in the company as opposed to paying a cash bonus. In these circumstances, the gain derived by employees pursuant to the implementation of the scheme is, by and large, taxed as normal income in accordance with section 8C of the Income Tax Act 58 of 1962 (ITA).

Notably, however, while payments of salaries or cash bonuses to employees are generally deductible in the hands of an employer as it is generally considered a business expense, the issuing of shares to employees is typically not allowed as an income tax deduction. There are, however, various alternative share incentive schemes that potentially support the claiming of an income tax deduction by the employer, provided certain circumstances are met. The claiming of an income tax deduction by the employer ensures these share incentive schemes are attractive and aligned from a commercial perspective with paying cash bonuses and the like.

While the South African Revenue Service (SARS) has issued several rulings based on slightly different sets of facts that confirmed the principle that a capital contribution pursuant to a share incentive scheme may well be tax deductible in the hands of the employer companies, it was conversely announced in the Budget Review Documents as far back as the 2013 National Budget Speech that Government was reviewing the deductibility of expenditure in relation to share incentive schemes. Its against this backdrop, that we examine the judgment in the *C:SARS v Spur* case which has raised intensive debate as to the ongoing attractiveness of share incentive schemes as a form of compensation.

Background facts

Spur Corporation Limited (Spur HoldCo) is the holding company and 100% shareholder of Spur Group Proprietary Limited (Spur). Spur, the main operating company of the Spur Group, is thus a wholly owned subsidiary of Spur HoldCo. The Spur Group (including Spur and Spur HoldCo) resolved in 2004 to implement a share incentive scheme in terms of which eligible employees of Spur were afforded the opportunity to participate in the share incentive scheme to promote the growth and profitability of the Spur Group.

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In simple terms, the contribution by Spur to the Trust of R48 million was used by the Trust to purchase the NewCo preference shares. The NewCo would then use the subscription price for the preference shares to acquire the shares in Spur HoldCo.

After 18 months of planning, Spur HoldCo established the Spur Management Share Trust (Trust). Importantly, Spur HoldCo was at that stage the sole capital and income beneficiary of the Trust. Spur made a capital contribution of R48,471,714 (Contribution) to the Trust in the 2005 year of assessment, having agreed to contribute a non-refundable expense to the Trust to fulfil its purpose. The participants in the share incentive scheme (employees of Spur) were added in December 2010 as beneficiaries of the Trust, but only stood to benefit from dividends received by the Trust and nothing further. Spur HoldCo remained the sole capital beneficiary of the Trust.

The participants in the share scheme were offered the opportunity to acquire ordinary shares in a newly incorporated private company (NewCo) at par value in proportions determined by Spur HoldCo. The purchase price of the NewCo shares was settled in cash by each participant upon the issuing of the NewCo shares on 15 December 2004. The participants were not entitled to freely dispose of the NewCo shares for a period of at least seven years. Those participants who left Spur's employment during this period forfeited their shares, which were then re-allocated to other participants.

Separately, the purpose of the Contribution was for the trustees of the Trust to apply the Contribution (and any income derived from it) by subscribing for preference shares in the NewCo, which in turn, would apply the aggregate subscription price received towards the acquisition of Spur HoldCo shares. In simple terms, the Contribution by Spur to the Trust of R48 million was used by the Trust to purchase the NewCo preference shares. The NewCo would then use the subscription price for the preference shares to acquire the shares in Spur HoldCo.

After the scheme had been implemented and commenced operating, the NewCo received dividends from time to time through its holding of the Spur HoldCo shares. The NewCo retained the dividends to assist in meeting its preference share obligations towards the Trust. In December 2009, the NewCo redeemed the preference shares for an amount of approximately R48 million while the preference dividends in the amount of approximately R22 million were distributed to the Trust. Notably, the redemption of the preference shares and the payment of the preference dividends were settled by way of the NewCo distributing a total of 6,688,698 Spur HoldCo ordinary shares to the Trust. The Spur Holdco shares had a total agreed value equal to the redemption (of R48,471,714) and preference dividends (of R22,562,254).

Soon after settling its preference share obligations, the NewCo declared dividends to the holders of the NewCo shares (i.e. the employee participants). The share incentive scheme was subsequently terminated and the NewCo was deregistered on 10 December 2012. The Trust remains in existence and continues to hold Spur HoldCo shares that were distributed to it by the NewCo.

Issue in dispute

Spur claimed the Contribution as a deduction against its taxable income in terms of the provisions of section 11(a) of the ITA. The claimed deduction was (in terms of section 23H of the ITA), spread over the seven-year period of the anticipated benefit to be derived, i.e. between 2005 and 2012. SARS initially allowed the deductions, however, after conducting an audit into Spur's tax affairs for the 2010 to 2012 tax years (which was later extended to include the 2004 to 2009 tax years), SARS

The end of share incentive schemes?*...continued*

The matter proceeded to the Tax Court (sitting in Cape Town) which found that the purpose of the expenditure was to incentivise key staff members of Spur through a share incentive scheme.

disallowed the deduction by way of issuing additional assessments. The basis of the disallowance was that the expenditure (i.e. the R48 million Contribution) was not "*in the production of income*" and therefore did not qualify for a deduction under section 11(a) of the ITA.

The matter proceeded to the Tax Court (sitting in Cape Town) which found that the purpose of the expenditure was to incentivise key staff members of Spur through a share incentive scheme. In the result it found that there was a sufficiently close causal connection between the Contribution paid by Spur to the Trust and its production of income.

SARS then appealed the Tax Court judgment and the matter proceeded to the Western Cape High Court (before a full bench with three judges). The majority (two out of three judges) found in favour of the taxpayer and one held against the taxpayer. The High Court was satisfied that Spur had established a sufficiently close connection between the Contribution and Spur's income earning operations. It was specifically held that the purpose of the expenditure, i.e. the Contribution of R48 million, directly served to incentivise the participants and key managerial staff, and to promote the continued growth of Spur. The matter then proceeded to the SCA.

SARS' argument before the SCA

SARS argued that it made the Contribution to the Trust, of which Spur HoldCo was the sole beneficiary. Spur HoldCo was thus the only party to have benefited directly from the Contribution to the Trust in that it would receive the investment in the NewCo preference shares. In other words, the Contribution of R48 million and the preference share dividends at the time when the NewCo redeemed the NewCo preference shares would be for the benefit of the Trust, being Spur Holdco and not the employee participants. The causal link required in terms of section 11(a) between the expenditure incurred and the income earned was thus lacking. There was (if anything) only an indirect and insufficient link between the expenditure and any benefit arising from the incentivisation of Spur's key staff.

Taxpayer's argument before the SCA

While the Contribution could arguably have been to retain the money within the Spur Group, it was submitted by Spur that the dominant purpose in the establishment and implementation of the scheme was to protect and enhance Spur's business and its income by motivating its management employees to be efficient, productive and remain in Spur's employ. This would entitle it to claim an income tax deduction.

Judgment

The court unpacked the principles underpinning what is required in section 11(a). In particular, the key issue was whether the expenditure incurred was "*in the production of income*" or not. In this regard, the court referred to the well-known case of *Port Elizabeth Electric Tramway Co Ltd v CIR* 8 SATC 13, in which it was held that two questions arise when considering whether an expense is in the production of income, namely:

1) whether the act, to which the expenditure is attached, is performed in the production of income, and

2) whether the expenditure is linked to it closely enough (i.e. there must be a sufficiently close link).

The end of share incentive schemes? *...continued*

The SCA commented that the participants did not benefit directly, and even indirectly for that matter, from the making of the Contribution.

The SCA furthermore referred to *CIR v Genn and Co (Pty) Ltd* [1955] (3) SA 293 (A), where it was held that in deciding how the expenditure should properly be regarded, one has to assess the closeness of the connection between the expenditure and the income earning operations, having regard both to the purpose and to what it actually effects.

With reference to the leading authority, the SCA in this case concluded that there are two criteria that must be satisfied. First, the purpose of the taxpayer in incurring the expenditure in question, and whether the purpose was to produce an income. Second, whether a sufficiently close nexus or link exists between the expenditure and the ultimate production of income. It was, however, noted that these criteria establish that a mere existence of a nexus or link between the expenditure and the earning of income is not, on its own, sufficient to justify a deduction under section 11(a) of the ITA. A taxpayer must show an "*adequate closeness*" between the expenditure and the production of income.

The SCA commented that the participants did not benefit directly, and even indirectly for that matter, from the making of the Contribution. In support of this finding, the SCA referred to the taxpayer's evidence in the Tax Court in which the following was stated: "*[t]he 48 million in the form of now Spur Corporation shares is still sitting in the trust so directly they [the participants] have not benefited from the 48 million.*"

The SCA held that the Contribution of R48 million was used, wholly, to subscribe for preference shares in the NewCo. Furthermore, only the Trust held the NewCo preference shares, and only it was entitled to the return of the R48 million Contribution, plus the preference dividend on those shares. It was concluded that the participants had no right to any part of the Contribution, nor to the preference dividends that flowed from the investment thereof. Importantly, in terms of the Trust Deed, only Spur HoldCo would, as the capital beneficiary, have any right to the ultimate delivery of the R48 million Contribution and any yield from it.

Separately, it was explained by the taxpayer that the Contribution by Spur was in effect a funding mechanism for the scheme, which was to remain in place for most of the duration of the scheme. In this manner, the participants were not exposed to the risk of a decrease in the price of Spur HoldCo shares, whereas the NewCo bore this risk. As per the taxpayer's evidence referred to by the SCA, the purpose was always for the R48 million to remain within the Spur Group and not to transfer it to the benefit of the participants, which is ultimately what the Contribution achieved.

Applying the principles in, amongst others, *PE Tramway v CIR*, the SCA concluded that the purpose of Spur in incurring the expenditure was not to produce income, as required by section 11(a) of the ITA, but to provide funding for the scheme, for the ultimate benefit of Spur HoldCo. There was only an indirect and insufficient link between the expenditure and any benefit arising from the incentivisation of the participants. The Contribution was therefore not sufficiently closely connected to the business operations of Spur such that it would be proper, natural and reasonable to regard the expense as part of Spur's costs in performing such operations. The income tax deduction of R48 million was thus disallowed.

Prescription

Interestingly, the SCA then dealt with the prescription issue second, whereas ordinarily, the prescription issue is dealt with first and then only the merits of the matter. At issue was whether the additional assessments were issued by

The end of share incentive schemes?*...continued*

While the judgment is important for all taxpayers embarking on share incentive schemes and one should heed the warnings contained in the judgment, it certainly does not mean the end of share incentive schemes.

SARS lawfully, notwithstanding that the three-year period of limitation had already passed by the time it issued the additional assessments. SARS argued that section 99(2)(a) of the Tax Administration Act 28 of 2011 (TAA), being an exception to the general three-year period of limitation, was applicable in that the amount of tax chargeable in terms of the additional assessments was not so assessed by SARS in the relevant years of assessments due to misrepresentation and non-disclosure of material facts by Spur.

The basis for this argument was that in submitting its 2005 income tax return, Spur answered "*no*" to the following questions:

- Were any deductions limited in terms of section 23H?
- Did the company make a contribution to a trust?
- Was the company party to the formation of a trust during the year?

Furthermore, in its 2005 to 2008 income tax returns, Spur disclosed the amount of the deductions under "*other deductible expenditure*" as opposed to the specific line item provided for in relation to section 23H. The SCA held that these acts by Spur amounted to deliberate misrepresentation and a non-disclosure of material facts and it commented that it simply could not amount to any inadvertent error. In assessing the second requirement to raise an assessment in terms of section 99(2)(a) of the TAA (i.e. the causal link between the act and the outcome of SARS under-assessing), it was held that the disclosures by Spur in its return resulted in the matter not coming before an auditor within the three-year period.

The SCA had the following further harsh warning to taxpayers:

> *"[A]s a matter of policy, a court would be loath to come to the assistance of a taxpayer that has made improper or untruthful disclosures in a return. Clearly, this would offend against the statutory imperative of having to make a full and proper disclosure in a tax return."*

The SCA thus held that SARS was not precluded by section 99(1) of the TAA to raise the additional assessments despite the three-year period having elapsed.

Observation

There has been extensive debate regarding the two important decisions handed down by the SCA in this case in respect of capital contributions to share incentive schemes and prescription of tax assessments. It is important to bear in mind that while there is a long line of cases on the requirement of "*in the production of income*" in the context of claiming a section 11(a) income tax deduction, each set of facts and circumstances are different. In this case, the SCA focused on specific facts that distinguished it from other share incentive schemes, especially the fact that the Contribution remained within the Spur Group and that the participant employees only indirectly benefited (if at all) from the Contribution. Therefore, while the judgment is important for all taxpayers embarking on share incentive schemes and one should heed the warnings contained in the judgment, it does not mean the end of share incentive schemes. Taxpayers, however, would be well advised to carefully consider their current arrangements in light of the judgment and to take every precaution that their tax returns are correctly submitted.

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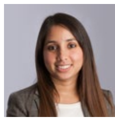

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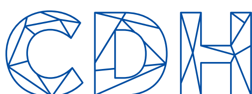

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