DLA CLIFFE DEKKER HOFMEYR

TAX

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EMPLOYEE SHARE OWNERSHIP PLAN RULING

The tax implications for the various participants of a share incentive scheme are complex and the legislation is not necessarily clear. In recent years, share incentive schemes have been a particular focus of the South African Revenue Service (SARS) and National Treasury with regular amendments to the tax legislation. It is no wonder that we see a number of binding private and binding class rulings being issued by SARS that relate to share incentive schemes.

Binding Private Ruling No 161 (BPR 161) is one such recent ruling, released on 5 February 2014, which deals with the income tax and employees' tax consequences for the employer company and the trust used to facilitate an employee share ownership plan (ESOP).

The purpose of the ESOP is to allow qualifying employees to participate in the benefits attributable to the shares of the employer company's JSE listed holding company (HoldCo). We do not discuss the mechanics of the ESOP in detail but note that:

- A trust allocated notional units to the participants of the ESOP to determine their participation in the dividends and net capital proceeds attributable to the HoldCo shares.
- The employer company made an annual contribution to the trust, which would be used by the trust to acquire shares in HoldCo.
- As soon as the HoldCo shares had been acquired by the trust, the trust would confirm with the founder of the trust that units are available for allocation to qualifying employees. If the qualifying employees accepted the units they would become participants of the ESOP.
- Importantly, the rights attached to the units entitled the participants to:
  - An immediate vested right to dividends received by the trust;
  - An immediate vested right to the net capital proceeds realised by the trust upon disposal of the shares; and
  - A vested right to the shares held by the trust when the trustees exercise their discretion to vest the shares in the participants.
- The participants are 'locked-in' for a specific period and are not entitled to dispose of any of the units and/or shares during the lock-in period. A participants' participation in the ESOP is subject to a number of other restrictions.

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One of the more contentious issues which BPR 161 considered is whether the contributions by the employer company to the trust for purposes of the ESOP are deductible for purposes of s11(a), read with s23(g) of the Income Tax Act, No 58 of 1962 (Act). For instance, are such contributions by the employer company to the trust 'in the production of its income' and 'not of a capital nature'? These questions are especially relevant if one considers that the contributions received by the trust will not necessarily be included in its gross income (which was confirmed in BPR 161).

There is case law *(Provider v Commissioner of Taxes, 17 SATC 40)* to support the argument that provided the contributions to the trust are made by an employer company in respect of its own employees and the undertaking to do so is given upfront, the employer company should be entitled to a deduction for its contributions to the trust. BPR 161 confirmed that the contributions by the employer company to the trust for purposes of this particular ESOP will be deductible under s11(a), read with s23(g) of the Act. A similar ruling was issued in Binding Private Ruling No 50 (BPR 50).

However, in BPR 161, no opinion was expressed on the application of s23H of the Act. Whereas, in BPR 50, SARS indicated that the provisions of s23H would be applicable but did not indicate how one should apply the attendant provisions. The purpose of s23H of the Act is to match the date upon which the expenditure may be claimed by a taxpayer to the date upon which the benefit is enjoyed by the taxpayer (ie where the benefit is not enjoyed by the taxpayer in the same year of assessment). Unfortunately, it is not clear over which period the deduction is to be apportioned in BPR 161 or whether the employer company may be entitled to a deduction each year that a contribution is made to the trust.

Where an ESOP is implemented using a special purpose vehicle (SPV), the issue often arises that the SPV does not have the cash from which to withhold the employees tax obligations triggered as a result of the vesting of a restricted equity instrument in a participant in terms of s8C of the Act (ie upon the lifting of the 'lock-in period'). BPR 161 indicated that:

- If the trust does not have any funds, the employer company will be liable to withhold the employees' tax on each section s8C gain made by a participant; and
- If the trust does have funds, the trust will be required to register as an employer and withhold an amount of employees' tax.

It is worth mentioning that BPR 161 also indicated that the contributions by the employer company to the trust will not be subject to donations tax under s54 of the Act and that the contributions received by the trust will be of a capital nature and thus not included in the trust's gross income in s1 of the Act.

It should always be appreciated that binding private and binding class rulings are only binding between SARS and the applicant(s) to the ruling. Other persons may not cite binding private and binding class rulings in any proceedings, including court proceedings, against SARS. Taxpayers requiring certainty on the tax implications of share incentive schemes, which are complex and sometimes uncertain, should therefore apply to SARS for their own advanced tax rulings.

Andrew Lewis

RULING ON THE DEFINITION OF 'LISTED SHARES' FOR PURPOSES OF THE FOREIGN DIVIDEND EXEMPTION

The South African Revenue Service (SARS) released Binding Class Ruling No 42 on 7 February 2014. The factual circumstances in respect of which the ruling was made are as follow:

Company Y is a company incorporated and resident in foreign country Y. Company X is a company incorporated and resident in country X. Company X is also a wholly-owned subsidiary of Company Y. Company X is to be listed on the JSE Limited. Its business is investment in foreign debt instruments, on which it will receive interest returns.

Company X intends to raise funds for its business by issuing certain preferred securities. The preferred securities will be issued through its branch in country Y.

The preferred securities would:

- be redeemable after five years or more at the same amount paid for them;
- confer preferred rights to dividends;
- generally not carry any voting rights;
- rank *pari passu* with all other preferred securities; and
- rank in preference to ordinary shares.

The dividends payable in respect of the preferred securities would be:

- calculated with reference to a rate derived from the underlying foreign debt instruments;
- limited to the net revenue derived from the underlying debt instruments; and
- paid in cash.

Certain South African investors (the class of persons concerned) would be beneficial owners of dividends paid by Company X in respect of the preferred securities.

Section 10B(2) of the Income Tax Act, No 58 of 1962 (Act) provides that foreign dividends are exempt from normal tax in certain circumstances. Specifically, in terms of s10B(2)(d) of the Act, a foreign dividend will be exempt to the extent that the dividend is paid in respect of a 'listed share' and does not constitute a distribution of an asset *in specie*.

The issue that arises in these circumstances is whether the preferred securities constitute 'listed shares' and whether the South African investors would be able to rely on the foreign dividend exemption in respect of dividends paid on these securities.

A 'listed share' is simply defined in s1 of the Act as any share that is listed on a licensed exchange in terms of the Financial Markets Act, No 19 of 2012. The JSE Limited constitutes such a licensed exchange.

SARS ruled that:

- the preferred securities in question would constitute 'listed shares' for purposes of s10B(2)(6) of the Act;
- the dividends paid in respect of the securities would constitute 'foreign dividends'; and
- the dividends would not constitute a distribution of an asset *in specie*.

By implication, SARS ruled that the South African investors would in principle be able to rely on the foreign dividend exemption in s10B(2) of the Act.

Interestingly, SARS did not make any ruling in respect of whether the dividend income in the hands of the South African investors would be re-characterised as ordinary income in terms of s8E and 8EA of the Act.

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