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ALERT

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The judgment raised the question whether such capital contributions would henceforth always be considered non-deductible or rather whether it was a case of considering the merits and specific facts and circumstances of each case. Many taxpayers would thus have been relieved when reading SARS Binding Class Ruling 78 issued on 24 January 2022 (BCR 78) which, amongst others, determined the income tax consequences of an employee share incentive scheme. We discuss the SARS ruling in this article.

BACKGROUND FACTS

The applicants in BCR 78 (being resident companies forming part of the same group of companies) proposed implementing an employee share scheme. Importantly, the purpose of the employee share incentive scheme was to incentivise all the participating employees by affording them the opportunity to participate in the economic benefits and appreciation in value in the shares held by the share incentive trust that would be driven by their endeavours. Critically, this would be expected to be achieved by the participating employees being entitled to on-going dividends and indirectly the capital appreciation of the scheme shares by virtue of being entitled to so-called milestone distributions and leaver distributions as defined in the scheme rules and trust deed.

The proposed transaction steps of BCR 78 envisaged a typical share incentive scheme. In particular –

- The applicants (being the relevant employers of the group of companies in question) would make cash contributions to the co-applicant (being a share incentive trust).
- The co-applicant trust would use the proceeds of the contributions to acquire shares in the ultimate holding company of the group of companies in question (Holdco).
- The trustees of the co-applicant would allocate units in the co-applicant to the participating employees.

SARS Binding Class Ruling 78 provides welcome clarification for share incentive schemes

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- A participating employee would be entitled to the following benefits in terms of the trust deed of the co-applicant:
  - proportionate share of 50% of any dividends received in respect of the scheme shares;
  - milestone distributions after an initial period of four years participation in the scheme and thereafter every five years of completed participation in the scheme; and
  - leaver distributions, being equivalent to milestone payments (and essentially determined on the same basis) payable to a participating employee that ceases employment with an applicant.
- The co-applicant would receive the gross foreign dividends that vest in the participating employees and would pass on the net amount (foreign dividend less the dividends withholding tax (DWT) at the applicable reduced rate) to the participating employees.
- The co-applicant would annually issue a certificate to participating employees certifying the amount of Holdco dividends derived by them and the amount of DWT accounted for by the trust on their behalf.

SARS RULING

SARS ruled, amongst others, as follows:

> *The contributions to be made by the applicants to the co-applicant (share incentive trust) would constitute expenditure deductible under section 11(a) read with section 23(g), subject to the application of section 23(h).*

BCR 78 thus reaffirms the principle that a contribution to a share incentive trust may well be deductible for income tax purposes depending on the specific facts and circumstances. On the back of the SCA judgment in *C:SARS v Spur Group*, this is welcome clarification for taxpayers implementing share incentive schemes although taxpayers would be well advised to consider existing and future arrangements given the recent spotlight on such share incentive schemes. In particular, one should bear in mind that SARS rulings are not binding between SARS and all taxpayers and are based on specific sets of facts.

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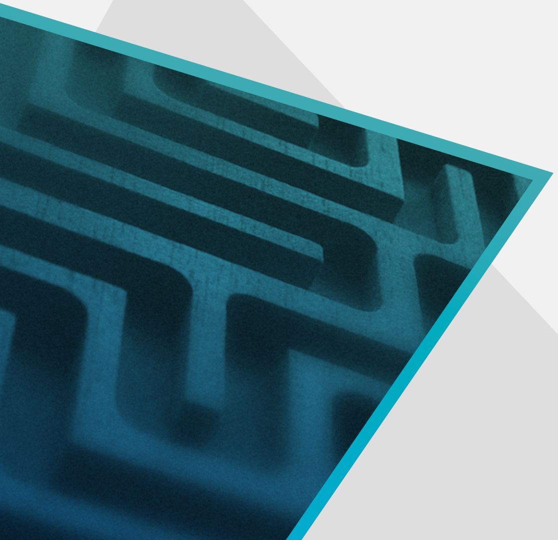

Pandemic affecting (place of) effective management

The place of effective management (POEM) principle is applied to determine the tax residence of a company. Where it is determined, for example, that a company is tax resident in South Africa, it will be taxed in South Africa on its worldwide income. However, the impact of the COVID-19 pandemic on the application of the POEM test must also be taken into account, especially in the case of companies with multiple offshore subsidiaries.

On a practical level, a situation may arise where a multinational company with offshore subsidiaries needs to consider how the location of the directors of the offshore subsidiaries, may affect the POEM of these subsidiaries. The importance of POEM can arise in a variety of scenarios and should, especially during the somewhat extraordinary time of a global pandemic, be given due attention.

It is widely known that the COVID-19 pandemic has resulted in travel restrictions, resulting in some chief executive officers, or other senior executives and/or board members of foreign companies, being unable to travel from South Africa to attend board meetings, or conduct business in the country where that company is tax resident. However, the question then arises as to whether this places the company at risk of being pulled into the South African tax net by virtue of its POEM.

Considering the myriad of both permanent and temporary changes to the current working environment, such as pandemic imposed travel restrictions and new workplace policies, the most notable of which being the "*work from home*" policy, it may be worthwhile for corporate taxpayers to reassess its POEM. As a result, in many instances, a scenario can arise where the key commercial decisions of a corporate taxpayer are being made outside of the jurisdiction in which it is based. This may have an adverse, and unintended impact on the POEM analysis of the taxpayer.

It is therefore important for companies to be cognisant of the criteria and guidelines provided by both the Organisation for Economic Cooperation and Development (OECD) from time to time, and by the South African Revenue Service (SARS) in considering the POEM of a company.

From the outset, it is important to note that the OECD has stated (3 April 2020) that –

> *"It is unlikely that the COVID-19 situation will create any changes to an entity's residence status under a tax treaty. A temporary change in location of the chief executive officers and other senior executives is an extraordinary and temporary situation due to the COVID-19 crisis and such change of location should not trigger a change in residency, especially once the tie breaker rule contained in tax treaties is applied."*

From a South African perspective, it should be noted that the term "*place of effective management*" is not defined in the Income Tax Act 58 of 1962. SARS' enforcement and consideration of POEM is constantly developing, and its current approach is contained in SARS Interpretation Note 6 (2015) (IN 6).

Pandemic affecting (place of) effective management

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One of the most critical factors as set out in IN 6 as set out in IN 6 are, a company's POEM will be deemed to be the place where key management, and commercial decisions that are necessary for the conduct of its business as a whole are in substance made. The analysis, however, considers a number of factors which include:

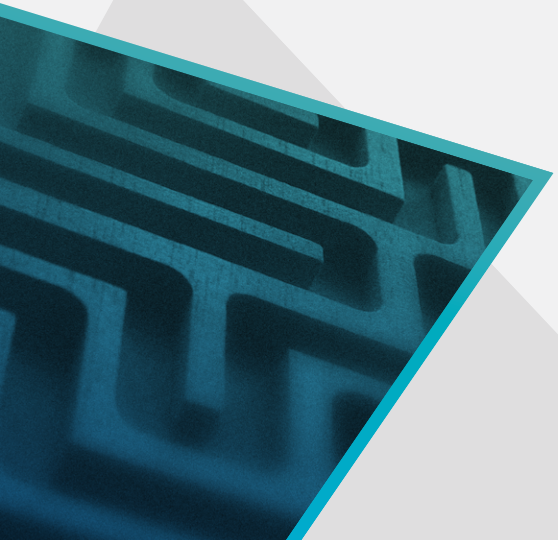
- where the real top level of management or realistic, positive management of the taxpayer was exercised;
- where decisions are made at more than one location, the company's place of effective management will be the location where those decisions are primarily or predominantly made;
- a substance over form test, which requires the identification of those persons in a company who actually "*call the shots*" and exercise "*realistic positive management*"; and
- importantly, IN 6 also recognises that changes in telecommunications, information technology, global travel and modern business practices can impact on the place of effective management.

Accordingly, physical meetings of the board may no longer be required, or it may not be possible that the majority of the directors or the key directors with decision-making powers, are in the same location as the physical meeting. This is not a fatal consideration in the overall analysis of POEM, but one of the factors that should be considered. IN 6 provides that it is important not to place an undue focus on the location where board meetings take place without considering the surrounding facts and circumstances of a particular case.

From an international tax perspective, the OECD guidelines are set out hereunder. It is important to note that tax treaties also cater for a situation where companies have dual residence as a result of the company being physically located in one jurisdiction and its POEM being elsewhere. In this instance, most treaties contain a "*tie breaker rule*" which ensure that the entity is resident in only one of the states.

The determination of POEM from an OECD perspective is largely similar to that set out in IN 6 and takes into consideration all the facts and circumstances over the determination period. Specifically, the OECD Commentary on Article 4 of the OECD Model Tax Convention illustrates the range of factors that the competent authorities are expected to take into consideration to make their determination, which includes:

- where the meetings of the company's board of directors or equivalent body are usually held;



Pandemic affecting (place of) effective management

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- where the chief executive officer and other senior executives usually carry on their activities; and
- where the senior day-to-day management of the company is carried on.

The OECD generally considers the concept of "*place of effective management*" as being ordinarily the place where the most senior person or group of persons (for example a board of directors) made the key management and commercial decisions necessary for the conduct of the company's business.

Therefore, all relevant facts and circumstances should be examined to determine the "*usual*" and "*ordinary*" place of effective management, and not only those that pertain to an exceptional and temporary period such as the COVID-19 crisis.

Having regard to the guidelines and criteria considered by both the OECD and SARS, the question of whether having executives making key commercial decisions whilst not physically in the same jurisdiction as the company impacts POEM, is dependent on the specific facts and circumstances. As outlined above, to the extent that the circumstances point to an "*extraordinary and temporary situation due to the COVID-19 crisis*", then it is unlikely that POEM will be impacted. However, the situation may become slightly trickier when, for example, travel restrictions and bans are relaxed and executives are no longer prevented from being physically in the jurisdiction of the company concerned. In this scenario, where executives have become comfortable working from their home country, and the convenience of technology and revised post-pandemic work-place policies allow for seamless running of the company from some other location, there is a real risk that POEM is impacted.

To the extent that a company has a POEM issue that is undetected by the checks and balances within the entity and is subsequently subject to an investigation by a revenue authority which deems the POEM of the company to be another jurisdiction, the company may find itself in prolonged engagement with that revenue authority to remedy the failure to account for tax in the correct jurisdiction.

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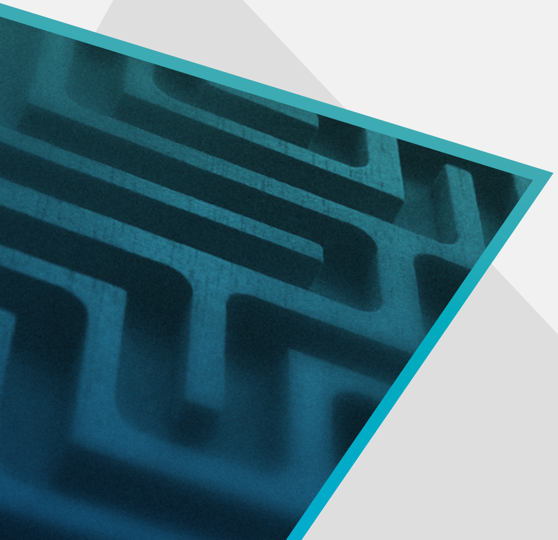

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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