South African Institute of Tax Professionals

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The National Treasury
240 Madiba Street
PRETORIA
0001

The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
PRETORIA
8000

BY EMAIL: Nombasa Nkumanda (nombasa.nkumanda@treasury.gov.za)
Yanga Mputa (yanga.mputa@treasury.gov.za)
Adele Collins (acollins@sars.gov.za)
Gerrie Swart (gswart@sars.gov.za)

RE: FOLLOW-UP SUBMISSION: EMPLOYEE SHARE SCHEME

We thank you for the meeting on Monday, 30 May 2016 concerning the ongoing difficulties with section 8C. Provided below is a summary of our views in respect of a potential way forward.

1. Background

As you know, the purpose of section 8C is to prevent high-end salary workers from converting salary (i.e. amounts taxable as ordinary revenue) into capital gain or some other amount subject to unjustifiably low rates. As also discussed, beneficiaries of section 8C schemes fall into two groups.

- *High-end executives and private investors:* This group is the main object of section 8C. This group is merely seeking to reduce the tax burden on service income via tax planning. Many of these stakeholders create these schemes when a new joint venture is formed or when acquiring target company operations. Most operate in terms of privately (e.g. non-public) shares. Many of these stakeholders directly or indirectly pressure tax firms into these schemes as a precondition for tax firm engagement in terms of the larger corporate transaction at issue.

- *Black Economic Empowerment partner and rank-and-file employees:* Share schemes for large empowerment communities and empowerment employees have proven the most effective means of supporting back economic empowerment as opposed to focusing on an elite (politically connected) few. In addition, share schemes are still fairly common as a method of rewarding rank-and-file employees in the case of listed shares.

Most holders of section 8C shares in terms of the latter group are comfortable with ordinary revenue treatment when surrendering their shares because tax payments and cash-flows match. Any dividends received are incidental to their share interests (and are sometimes used to pay the interest for borrowed shares). This group of section 8C shareholders is seeking the same dividend treatment as outside holders of shares in the same class (e.g. if the section 8C shareholders hold a small portion of listed shares, it is perceived that the dividends arising from these shares should be treated the same for both section 8C shareholders and non-section 8C shareholders).

The executive/private investor group, on the other hand, are clearly driving tax schemes for a reduced tax burden. This group is consistently seeking to avoid section 8C treatment and is the cause of continuing avoidance schemes requiring government intervention. The result has been an uncertain legislative landscape for the innocent remainder. It is hoped that these avoidance schemes can be closed so that that the section 8C landscape can be settled once-and-for-all for the more legitimate remainder.

2. Problem #1: Share-Buy Backs

The most obvious avoidance is the use of share buybacks and other company share reacquisitions of section 8C shares. From the perspective of the employee, the shares are disposed of or otherwise surrendered just like any disposal. However, because the company itself (as opposed to a third party) is purchasing the shares, the net result is dividend treatment due to the technicalities of the dividend definition. Therefore, it is suggested that dividend relief not apply to any company reacquisition of section 8C shares – regardless of the nature of the shares or the size of the payment amount.

3. Problem #2: Dividend Stripping

The other common mechanism for converting section 8C gain into dividends is the use of dividend stripping transactions. In these cases, the so-called "dividend" amounts distributed to the employee strip the underlying long-term value of the section 8C shares. These gimmicks come in several isolated or combined forms.

- The shares themselves may only produce dividends (having no corpus).

- The dividends in respect of the shares may be so large in relation to underlying value of the share so as to strip underlying value for an indefinite period.

- Underlying shares of the operating company be isolated via the use of an intermediary company. The intermediary can hold the underlying operating company shares so as to accumulate cash-flows with the employees holding ordinary (no special feature) intermediary shares. The intermediary shares can then generate largescale dividends (without ordinary gain payments) give the isolated nature of the intermediary company.

Given the pressure by certain private participants to eliminate section 8C gain, the current exemption for "dividends" from section 8C shares should be narrowed further. It is obvious that the "equity share" limitations of section 10(1)(k)(i)(proviso (dd) are insufficient.

The dividend yield per annum vis-à-vis the overall value also needs to be limited (e.g. perhaps to 10 per cent). In addition, shares should be excluded where the value upon redemption is expected to be less than the anticipated dividends over a 10-year period (assuming the company remains solvent). It will be hard to target special purpose companies that merely hold shares because these intermediaries often exist for non-tax commercial reasons.

4. Note on trust share scheme rigidity

One practical difficulty in this area is the rigidity of section 8C schemes when the shares at issue are widely-held. Changes in law can be very disruptive to widely-held share schemes because the rules of the scheme are locked-in by contract and cannot be changed by the signature of one or two parties.

We would therefore request that broad changes (i.e. such as a proposal to treat all dividends in respect of section 8C shares) should be prospective only. For this purpose, a prospective outcome would mean that a new broad anti-avoidance rule would only apply to all shares held by an individual on or after a specified date (e.g. 1 June 2017). Narrow changes, such as those suggested above, can be accelerated (e.g. dividends on or after a specified date).

5. Longstanding capital gains trust issue

One longstanding issue is the potential for capital gains tax in respect of section 8C trust share schemes. Given that most of these trusts are discretionary in nature, the disposal of these shares will trigger capital gain. Of concern is the potential for capital gains by the trust when disposing of the shares (with the subsequent section 8C ordinary charge by the employee holder of the share). This disposal can occur one of two ways:

- The trust can transfer the shares to the employee; or
- The trust can sell the shares to third parties with the cash going to the holder of section 8C beneficial trust interests.

Admittedly, a good argument can be made that a transfer of shares to an employee is not a deemed capital gains event under paragraph 38 of the Eighth Schedule because the transfer is at arm's length. However, two problems exist. Firstly, a transfer to an employee may be viewed as being for actual consideration of market value because the holder of the trust interest is surrendering those trust rights in exchange. Alternatively, if the trust interest is to be ignored, the transfer of the section 8C shares to the employee is arguably for some form of service of equal value.

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Moreover, even if a direct section 8C shares to employees is viewed as a transfer for zero consideration (generating a probable clogged loss), the transfer of these shares by a trust to third parties for cash is clearly a CGT event.

The underlying problem is that two levels exist for share trust schemes. A tax potentially exists at the discretionary trust level in terms of capital gains with another section 8C charge for the employee holder of the beneficial trust interest. Yet, the economic interest is only one. The employee is holding a beneficial trust interest that will be transformed into an underlying share or cash. From a policy perspective, this profit is arguably taxed as ordinary revenue like salary – no reason exists to impose an additional capital gain charge on the same amount. We would suggest that section 8C shares be excluded from the Eighth Schedule (under paragraph 11) if held in trust where the beneficial trust interests are subject to section 8C.

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SAIT thanks National Treasury and SARS for the open engagement on this very important matter. We appreciate the early discussions before the proposed legislation is sent to the Standing Committee on Finance.

Yours sincerely,

Keith Engel
Chief Executive