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Employee share incentive schemes: potential double tax on gains distributed by share trusts

Thank you for the opportunity to participate in the Annexure C workshop on Personal Income Tax on 6 December 2016. During the workshop the question was raised under which factual circumstances double tax could arise on the same gain as submitted under point 11 of our 24 November 2016 letter. We mentioned an employee share incentive scheme used in a typical B-BBEE structure as an example and would like to take this opportunity to provide further detail.

Example of a typical B-BBEE structure using an employee share scheme

Annexure A contains a basic diagram of the structure.

A typical B-BBEE structure could be structured along the following lines:

- An operating company (OpCo) needs to be empowered for commercial/regulatory reasons.
- All the ordinary shares in the operating company are owned by its holding company (HCo).
- The shares in HCo could be widely held and may even be listed.
- BEE company (BEECo) is formed.
- BEECo incurs debt to fund the acquisition of 26% of the shares in OpCo from HCo (at market value or a so-called BEE discount to market value).
- Initially the value of the BEECo shares is nominal or low because of the debt used to acquire the shares in OpCo from HCo.
- The shares in BEECo will typically be acquired by an employee share trust that meet empowerment criteria when the structure is set up.
- Throughout the life of the B-BBEE structure it will be important that the empowerment criteria continue to be met, for example, that BEECo continues to be held for the benefit of Historically Disadvantaged Individuals (HDI).
- When the structure is set up, the employee share scheme will be put in place.
- Eligible HDI employees will be identified and invited to participate in the employee share scheme.
- These HDI employees will become beneficiaries of the employee share trust and will be issued with notional linked units to symbolise their trust interest.
- Each linked unit would symbolise their personal right as a vested beneficiary of the trust to the gain on the disposal of the underlying BEECo share upon vesting.
- There will be an initial lock-in period (of say 5 years) before the BEECo shares can be disposed of.

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- After the lock-in period the trust will sell the BEECo shares and the gain will legally vest in the HDI employees and be paid to them. This is symbolised by a so-called “buy-back” of the notional linked unit by the trust from the HDI employees.
- These symbolical concepts, such as notional linked units are used to explain the scheme to the employees and to aid their understanding of, and acceptance of the scheme. The essence of the scheme is that these employees are entitled to the economic gain on the sale of the BEECo shares and that the trust administers the scheme for their benefit. When the shares are sold, the gain is distributed to the employees.
- The process of ensuring that OpCo remains empowered after the initial period of the B-BBEE structure is often complicated as the interest in BEECo can only be sold to willing buyers who meet the empowerment criteria.
- The use of the trust structure enables the group to retain sufficient control over the disposal of the shares to ensure that the B-BBEE structure can be retained (or replaced by a suitable new B-BBEE structure) and OpCo can remain empowered. The trust achieves this by ensuring that the buyers of the shares meet the empowerment criteria.

Tax concern

As discussed in our submission, our concern is that the same economic gain on the sale of the BEECo shares could potentially be subject to income tax in the hands of the employee as well as capital gains tax in the hands of the trust. Our concern is based on a strict interpretation of the legislation, as amended in 2015 by the insertion of paragraph 80(2A) of the Eighth Schedule:

- The HDI employees would have acquired the linked units as restricted equity instruments (as defined in section 8C) as the value of their personal right to the gain on disposal of the share by the trust is determined with reference to the underlying BEECo share.
- When the restricted equity instruments vest after the 5-year lock-in period and the BEECo shares are sold by the trust, the gains realised by the trust vest in, and are paid to, the employees and are subject to income tax in their hands in terms of section 8C.

- In addition, in terms of paragraph 80(2A) of the Eighth Schedule, if the capital gain is vested by the trust in the beneficiary by reason of the section 8C vesting of that equity instrument in that beneficiary, the conduit principle, contained in paragraph 80(2), does not apply. The capital gain is therefore taxed in the hands of the trust as opposed to the hands of the employees.

Recommendation

We have noted the response under point 3.2 of the Final Response Document on Taxation Laws Amendment Bill, 2016 and Tax Administration Laws Amendment Bill, 2016 (“the Response Document”). It is indicated that a technical correction to paragraph 64C will be made in the 2017 legislative cycle in order to extend paragraph 64C of the Eighth Schedule to the Income Tax Act to provide that amounts included in the income of a person in terms of section 8C(1A) should be disregarded for capital gains tax purposes. We recommend that the same principle should apply to all section 8C gains in order to address the concern of double taxation.

Post scriptum: Binding private ruling 261: Repurchase of restricted equity instruments

The transaction described in BPR 261, that was issued on 30 January 2017, is very similar to our example. The ruling confirms in paragraph 7d) that section 8C will apply to the gain. Unfortunately, the ruling made in BPR 261 does not provide clarity on the CGT treatment, a view expressed by more than one tax specialist. It is not clear from the ruling whether or not the gain on the sale of the shares will be subject to CGT. The ruling states in paragraph 7a) that the proceeds received by the trust on the disposal of the shares will accrue to the trust (per implication not the beneficiary) which will calculate any capital gain. It goes on to state in paragraph 7c) that the gains will not be taxable in the trust under paragraph 80(2) and that paragraph 80(2A) will also not apply. It is not at all clear how, if paragraph 80(2A) does not apply, section 80(2) would be rendered ineffectual. The remaining uncertainty supports our recommendation that legislative certainty should be provided.

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We would welcome further engagement.

Yours sincerely

Erika de Villiers
Head of Tax Policy

Annexure A

Example of a typical B-BBEE structure using an employee share scheme

