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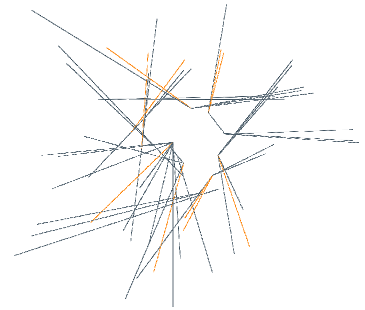

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Your reference	Our reference	Date
	DTLAB - s 8CA	12 September 2016

Dear Mr Wicomb

SUBMISSION: DRAFT TAXATION LAWS AMENDMENT BILL, 2016

1. Introduction

1.1 Thank you for the opportunity to comment on the draft Bill. We attach our detailed submission, sent to National Treasury and SARS in response to the Bill.

1.2 We set out herein a further submission in relation to the proposed section 8CA deduction, which we wish to present to the Parliamentary hearings on 14 September 2016.

Senior Partner: JC Els **Managing Partner:** SJ Hutton **Partners:** RB Africa NG Alp OA Ampofo-Anti RL Appelbaum AE Bennett DHL Booysen AR Bowley PG Bradshaw EG Brandt JL Brink S Browne MS Burger RI Carrim T Cassim RS Coelho KL Collier KM Colman KE Coster K Couzyn CR Davidow JH Davies PM Daya L de Bruyn JHB de Lange DW de Villiers BEC Dickinson MA Diemont DA Dingley G Driver HJ du Preez CP du Toit SK Edmundson AE Esterhuizen MJR Evans AA Felekis GA Fichardt JB Forman KL Gawith MM Gibson SJ Gilmour H Goolam CI Gouws PD Grealy A Harley JM Harvey MH Hathorn JS Henning KR Hillis XNC Hlatshwayo S Hockey CM Holfeld PM Holloway HF Human AV Ismail KA Jarvis ME Jarvis CM Jonker S Jooste LA Kahn M Kennedy A Keyser PN Kingston CJ Kok MD Kota J Lamb L Marais S McCafferty V McFarlane MC McIntosh SJ McKenzie M McLaren SI Meltzer SM Methula CS Meyer AJ Mills JA Milner D Milo NP Mngomezulu J Moolman VM Movshovich M Mtshali SP Naicker RA Nelson BP Ngoepe A Ngubo ZN Ntshona MB Nzimande L Odendaal GJP Olivier N Paige AMT Pardini AS Parry S Patel GR Penfold SE Phajane MA Phillips HK Potgieter S Rajah D Ramjettan GI Rapson NJA Robb DC Rudman M Sader JW Scholtz KE Shepherd DMJ Simaan AJ Simpson J Simpson N Singh P Singh MP Spalding L Stein PS Stein MW Straeuli LJ Swaine Z Swanepoel A Thakor A Toefy PZ Vanda SE van der Meulen M van der Walt N van Dyk A van Niekerk JE Veeran D Venter B Versfeld MG Versfeld TA Versfeld DM Visagie J Watson KL Williams K Wilson RH Wilson M Yudaken **Chief Operating Officer:** SA Boyd

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2. Proposed insertion of section 8CA

2.1 Proposed amendment

2.1.1 The new provision intends to provide a corporate income tax deduction for expenditure incurred in offering certain employee share ownership schemes, namely restricted equity schemes.

2.1.2 The new provision has been drafted as part of a suite of amendments to the rules pertaining to restricted equity instruments and the amounts accruing to employees in respect of such instruments.

2.1.3 From 1 March 2017, all amounts accruing to employees holding restricted equity instruments shall be taxed as income, including:

2.1.3.1 gain on the vesting or disposal of such instruments (exiting section 8C);

2.1.3.2 return of capital on such instruments, excluding a return in the form of a restricted equity instrument (new section 8C(1A);

2.1.3.3 capital gains in respect of such instruments (new section 8C(1A)); and

2.1.3.4 dividends accruing in respect of such instruments (new section 8C(1A) read with revised section 10(1)(k)(i)(ii)).

2.1.4 Although these amounts shall be taxed as remuneration in the hands of employees (on the basis that they are effectively fringe benefits), the employer will not receive any matching income tax deduction for such remuneration (as would be the case for other fringe benefits provided by employers).

2.1.5 In recognition of this, National Treasury has proposed that the new section 8CA provide an upfront corporate income tax deduction for the costs of restricted equity schemes. This conforms with the generally accepted 'matching principle' whereby amounts received by a taxpayer and taxed as income shall be treated as deductible in the hands of the payer.

2.1.6 While welcome in theory, the proposal has a number of flaws which will ensure that it does not achieve its purpose.

2.2 Problems identified

2.2.1 *Mis-match with respect to existing restricted equity instruments*

2.2.1.1 The new rules in section 8C(1A) and section 10(1)(k)(i)(ii) set out above shall include in income all amounts accruing to employees in respect of restricted equity instrument, even existing instruments held be employees.

2.2.1.2 Existing instruments were issued to employees in terms of the existing tax legislation, but shall be subject to the revised rules. For example, employees who currently hold restricted shares may receive dividends and be taxed at 15% like any other shareholder (in terms of a specific

rule to this effect in the existing section 10(1)(k)(i)(ii)). From 1 March 2017, such dividends shall be taxable at normal income tax rates.

2.2.1.3 While it is accepted that new tax rules will always impact existing arrangements, we submit that in the present instance the impact is particularly unreasonably given the intention of the suite of amendments.

2.2.1.4 National Treasury's intention, we understand, is that treating all amounts accruing on restricted equity instruments is justified because the new section 8CA will provide a corporate income tax deduction for such schemes. This was certainly the impression given at the National Treasury workshop. However, existing restricted equity instruments will never have had the benefit of a tax deduction when they were issued by the employer, yet future receipts and accruals will nevertheless be subject to income tax.

2.2.1.5 *Proposed solution*

2.2.1.6 The amendments to section 8C(1A) and section 10(1)(k)(i)(ii) which seek to include in income all amounts accruing in respect of restricted equity instruments should apply only to instruments issued after 1 March 2017. The existing rules should apply to existing restricted equity instruments.

2.2.1.7 This is also an issue of fairness, given that employers and employees created existing instruments under the expectation that the dividends would be taxed like any other shareholder. The rules are being changed before that existing equity vests.

2.2.2 *Double taxation of dividends*

2.2.2.1 Dividends are paid from after-tax profits and are not a tax deductible expense for employers.

2.2.2.2 From 1 March 2017, certain dividends paid to employees holding restricted equity will be taxed as income in the hands of employees, but such dividends will remain non-deductible for the employer in terms of the current rules.

2.2.2.3 Consequently, the amount from which the dividend is paid (profit) will have already been subject to 28% corporate income tax before it is received by the employee. It will then be subject to income tax in the hands of that employee, at up to 41%. The amount will have been subject to a total tax rate of up to **57.52%**

2.2.2.4 As noted above, National Treasury have apparently justified this double taxation on the basis that the scheme will have received a tax deduction upfront. As noted below, this assertion is misplaced. Furthermore, providing a tax deduction for the scheme itself does not justify levying double tax on the resulting dividends.

2.2.2.5 A restricted equity scheme has two components: a capital component (the equity issued by the employer and acquired by the employee, which

will be taxed as income when it vests or is disposed of) and an income components (ongoing dividends which are taxed on receipt). Both of these components must be considered in light of the matching principle.

2.2.2.6 To be fair and equitable, a deduction should be available for both the issue of the equity by the employer (which will be taxed in terms of section 8C in the hands of the employee when it vests) and for the dividend taxed as income on receipt by the employee.

2.2.2.7 The present version of section 8CA does not provide a deduction for the issue of the shares, nor for the payment of the dividend. It is therefore difficult to understand how the taxation in the hands of the employee is justified in terms of the matching principle.

2.2.3 *Deduction available only for expenditure 'actually incurred and paid'*

2.2.3.1 The proposed section 8CA deduction permits a corporate income tax deduction with respect to "expenditure actually incurred and paid" in respect of a restricted equity instrument scheme (as defined).

2.2.3.2 Such deduction is then spread evenly over the longest possible vesting period of the share scheme.

2.2.3.3 This deduction is therefore no improvement whatsoever on the existing section 11(a) deduction, read with section 23H. The new section 8CA deduction offers nothing in addition to what is already available, and is in fact more narrow in its application.

2.2.3.4 The main flaw with the proposed deduction is that, although the vast majority of restricted share schemes are created with the issue of shares, no deduction is available for the issue of such shares. The issue of shares is not "expenditure actually incurred and paid" and has never been deductible. Consequently, most existing schemes did not obtain a tax deduction when they were created (but will be taxed as income in terms of the new rules nonetheless, as noted at 2.2.1 above).

2.2.3.5 One of the only ways that a deduction can currently be achieved for an employee share scheme is by way of contribution to a trust which then acquires shares for the benefit of employees (and to obtain BEE points). This will remain the case even after the introduction of section 8CA.

2.2.3.6 To be successful, section 8C must permit a deduction for the issue of shares, as this is by far the most common way to create an employee share scheme.

2.2.3.7 We agree with National Treasury that it would be fair and reasonable to subject all the resulting amounts to income (e.g. gains, return of capital, dividends) if a deduction was obtained by the employer. However, that is not presently the case and will not be the case even after the introduction of section 8CA.

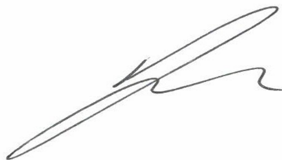
2.2.3.8 *Proposed solution*

2.2.3.9 It is accepted that providing an upfront deduction for the issue of shares would be problematic. Therefore, it is suggested that a deduction be available to the employer only when the restricted equity instrument, and amounts accruing thereon, are taxed in the hands of the employee. This would be a true application of the matching principle. Furthermore, the employer's deduction would be delayed until the employee was actually taxed on the resulting benefits, i.e. there would be both a timing match and a match of amounts taxed and deducted.

2.2.3.10 Consequently, we recommend that section 8CA provide a corporate income deduction for any amounts taxed in the hands of employees in terms of section 8C (including section 8C(1A)) and any dividends taxed in the hands of employees in terms of section 10(1)(k)(i)(ii), in the same year of assessment.

Please contact us should you wish to discuss the contents of this opinion further.

Yours faithfully



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