

TAX

The inadvertent 8c trap

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Section 8C of the Income Tax Act 1962 (the Act) includes in a taxpayer's income any gains or losses made upon the vesting of an equity instrument (usually a share in a company or an option) that is acquired by virtue of that taxpayer's employment or the holding of any office of director.

Its application generally arises in the context of employee share schemes with a taxpayer effectively being subject to section 8C as a result of one of two situations:

- a taxpayer acquires an unrestricted equity instrument for a purchase price, which is less than the market price (in which case the difference is taxed); or
- upon the vesting of a "restricted equity instrument" that was acquired by the taxpayer (in which case the excess of the market value at date of vesting over the purchase price is taxed).

It is the latter situation that taxpayers should pay special attention to as a "restricted equity instrument" is defined very widely and there may be clauses in the share purchase agreement, shareholders' agreement or company's memorandum of incorporation that one may not realise is, in fact, a restriction.

If classified incorrectly, the result may be that there are unintended tax consequences, potential penalties and interest payable to the South African Revenue Service.

INADVERTENT RESTRICTIONS

A "restricted equity instrument" is defined in section 8C(7) of the Act. The two most common restrictions are:

- where an equity instrument is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value; and
- where the taxpayer could forfeit ownership of the equity instrument or the right to acquire ownership of the equity instrument, at a price other than at market value.

The more obvious examples of a restriction would be clauses stating that:

- the equity instrument may not be sold for a certain period; or
- the holder of the equity instrument has to sell the equity instrument to the company for less than market value if he or she leaves the employ of the company before the expiry of a certain period.

However, one should also be aware of other restrictive clauses that, despite only arising in remote situations that are contingent on a certain event happening, nonetheless could qualify as a restriction for purposes of section 8C.

An example of such a clause would be a "bad leaver" clause (the purpose of which is to deprive an employee who leaves employment of benefits because of acting in a "bad" way) whereby, for example, if the employee conducts fraudulent activity, he or she forfeits the equity instrument. There are differing views on whether or not this is a restriction for section 8C purposes, but the risk is certainly there.

Another example might be if the memorandum of incorporation restricts all shareholders, whereby they may not transfer their shares without the approval of, say, the controlling shareholders. While they might have nothing to do with employee incentive and retention

policies, but is rather to stop the shares falling into the "wrong" hands, the existence of this restriction could impact on the status of the growth of an employee-shareholder's shares, i.e. subject the growth to income tax at 45% instead of CGT at 18%.

CONCLUSION

It is possible that many taxpayers are acting on the assumption that, because there are no glaringly obvious restrictions in the terms of the agreements to buy their shares, they hold "unrestricted equity instruments" and that, (on the assumption they were acquired for a purchase price equal to the market value) they will have no adverse tax consequences.

To avoid these unintended tax consequences or a situation, where a taxpayer is subject to a higher tax rate, not to mention to penalties and interest, because of incorrectly classifying their equity instrument as "unrestricted", taxpayers and employees should examine all terms related to the shares.



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