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The SCA rules on the deductibility of contributions to employee share incentive schemes and prescription

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SCA rules on the deductibility of contributions

Many employers implement employee share incentive schemes with the intention of incentivising and retaining employees. While this is a common occurrence, all having the same purpose, the actual methodologies as to how they are implemented can vary quite widely, often with differencing tax consequences for both the employer and the employees.

One such arrangement was implemented by Spur Group Proprietary Limited (Spur), which contributed approximately R48 million (the Contribution) to a trust (the Trust), established in furtherance of Spur's employee management incentive scheme. Spur, of the view that the purpose of the scheme was to "promote [Spur's] continued growth and profitability", thus believed that the expenditure of R48 million was sufficiently closely connected to Spur's income earning operations as to make it deductible for income tax purposes. Spur thus deducted the Contribution over a period of seven years in terms of the 'general deduction formula' found in section 11(a) of the Income Tax Act No. 58 of 1962 (Act), read together with section 23H of the Act.

It is worth mentioning that Spur's scheme differed from a more standard share incentive scheme, and was structured as follows:

- Spur's holding company, Spur Corporation Limited (Spur HoldCo) was the sole capital beneficiary of the Trust.
- The Trust, in furtherance of the scheme, incorporated an underlying company (NewCo), and subscribed for preference shares in NewCo.
- NewCo used the proceeds from the Trust to acquire shares in Spur HoldCo. The participant employees were then granted the opportunity to subscribe for ordinary shares (at nominal value) in NewCo.
- The preference dividends were serviced out of the dividends received on the Spur HoldCo shares.
- Eventually, the preference shares were redeemed and NewCo discharged its redemption obligations by delivering Spur HoldCo shares to the Trust (to the value of R48 million). NewCo thereafter disposed of the remainder of its Spur HoldCo shares for cash, using the proceeds received to declare cash dividends to the participant employees (i.e., its ordinary shareholders).

Tax Court and High Court decisions

SARS initially issued original assessments for Spur's 2005 to 2012 years of assessment, allowing the deductions. However, following an audit some years later (2015), SARS issued additional assessments disallowing the deductions on the basis that the Contribution was not incurred in the production of Spur's income. Spur disputed this and further argued that, even if SARS was correct and the Contribution was not deductible, the statutory periods (three years) for the 2005 to 2009 years of assessment had expired (colloquially referred to as 'prescription'), thus precluding SARS from raising additional assessments for those years.

The matter was first heard in the Tax Court, which ruled in favour of Spur. The matter was appealed by SARS and heard in the Western Cape Division of the High Court. The majority dismissed the appeal and again ruled in favour of Spur. As both the Tax Court and the High Court ruled in favour of Spur on the deductibility issue, the issue of prescription was not dealt with by them.

SCA Ruling

The matter was again appealed by SARS and, on 15 October 2021, the Supreme Court of Appeal (SCA) handed down its decision in *Commissioner for the South African Revenue Service* v *Spur Group Proprietary Limited* [2021] ZASCA 145.

Deductibility of the Contribution

SARS's argument was simple. Spur HoldCo was the only party to directly benefit from the Contribution, namely its investment in, and the dividends from, the preference shares in NewCo, as it was the sole capital beneficiary of the Trust.

In coming to its decision, the SCA relied on the seminal decision in *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue (PE Tramway)* where Watermeyer J explained the position as follows:

"... two questions arise (a) whether the act, to which the expenditure is attached, is performed in the production of income, and (b) whether the expenditure is linked to it ***closely enough.*** *"* (Emphasis added by the SCA)

In applying the two criteria, the SCA agreed with SARS in that Spur had not shown adequate closeness between the Contribution and its production of income and held:

"[38] ... the purpose of Spur in incurring the expenditure was not to produce income, as required by s 11(a) of the [Act]*, but to provide funding for the scheme, for the ultimate benefit of Spur HoldCo. There was only an indirect and insufficient link between the expenditure and any benefit arising from the incentivisation of the participants. The contribution was therefore not sufficiently closely connected to the business operations of Spur such that it would be proper, natural and reasonable to regard the expense as part of Spur's costs in performing such operations."*

Although Spur's facts did differ from the more standard share incentive scheme, employers should take note of the SCA's ruling and ensure that the requisite causal connection exists between their business operations and any contributions that they make to their share incentive schemes before they begin making any deductions under the 'general deduction formula'. In this regard it will be noted that SARS has issued at least three binding private rulings where these contributions to share incentive trusts ***have*** been allowed as deductions, but in those cases the connection was much closer, e.g., the share trust itself used the proceeds of the contribution to acquire the employer company's (or its holding company's) shares for delivery to the employees.

Section 99 of the Tax Administration Act No. 28 of 2011

The second issue was that of prescription and whether or not SARS was entitled to raise additional assessments after the statutory periods of three years had prescribed. Section 99 of the Tax Administration Act No. 28 of 2011 makes it clear that SARS may not issue an assessment three years after the date of assessment of an original assessment by SARS, **unless**, the reason that the full amount of tax chargeable was not assessed was ***due to*** (i) fraud, (ii) misrepresentation; or (iii) non-disclosure of material facts.

It was common cause that Spur had answered "no" to certain relevant questions on its income tax returns when the correct answers were obviously "yes". Spur's argument was that this was due to negligence and an inadvertent error rather than that of misrepresentation and non-disclosure of material facts (and even went so far as to blame its new accountant for these mistakes).

Spur further argued that SARS had all the facts at their disposal to raise additional assessments within the time limits, as Spur had submitted its annual financial statements with its tax returns. Spur also argued that, even if it was incorrect on these points, the failure to tax Spur was not "due to" the misrepresentation and non-disclosure, i.e., the requirement of causality was missing, as no SARS auditor had examined the returns during the three-year period.

As against this, SARS led evidence that the incorrect answers had resulted in certain risks with the returns not being triggered by the efiling computer system, and had the correct answers been given the returns would have been audited. On this basis the SCA rejected the argument and found against Spur here as well.

What is also of importance is that the SCA went so far as to say:

"[63] I should also add that as a matter of policy, a court would be loath to come to the assistance of a taxpayer that has made improper or untruthful disclosures in a return. Clearly, this would offend against the statutory imperative of having to make a full and proper disclosure in a tax return."

This bald statement is of concern, and only time will tell how SARS uses this "policy" statement against taxpayers in future.

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