Short notes on:

BBBEE OWNERSHIP COMPLIANCE: EMPLOYEE SHARE SCHEMES
THE DO’S AND THE DONT’S

Introduction
Since the recent amendment of the Broad Based Black Economic Empowerment Act 53 of 2003 and its regulations, i.e. the Codes of Good Practice, (jointly referred to as the “BBBEE Act”), whereby complying with the ownership requirement of the BBBEE scorecard, employee share schemes became more popular than ever.

Setting up an employee share scheme without suitably qualified professional assistance can have dire consequences for any company and its employees. Especially as this could lead to major (unforeseen) tax consequences for both the company and the employees concerned. So, the question is what benefit does the company and conversely the employees gain from this type of transaction? How are these benefits most suitably balanced to avoid unforeseen consequences?

Who really benefits?
An obvious benefit for the company / employer: compliance with the BBBEE Act and an increase in its BBBEE score, allowing it to participate in large contracts (e.g. with corporates), government contracts and tenders. The employees, on the other hand, will gain the right to share in the dividends of the company and have a say as shareholders of the company. It can be seen as a “win-win” for both parties.

In addition, if applied correctly – the next generation of committed directors and shareholders can be created.

However, the question remains as to how one can structure such an arrangement to benefit both parties and to ensure that the share scheme does not burden employees or the company with excessive tax liabilities?

One of the key considerations to bear in mind is the valuation formula for selling / transferring the shares into the Trust. We also recommend that the same formula for sale / transfer is applied when the company buys the Trust out / the shares back at a later stage. It is important that the advice of a specialist attorney, financial expert and tax practitioner is obtained so as to avoid:
1. Causing the Trust to buy the shares at an exorbitant price – thereby causing the incurrence of debt and forfeiting the BBBEE benefit of the transaction, at least, until the debt is paid;

2. A donation of shares is also, in my view, not a wise option as this would retain the BBBEE benefits but result in a substantial donations tax liability for the company / selling shareholder concerned and may further adversely affect the employee’s authentic commitment to the growth of the company;

3. Capital Gains Tax will result in the case of the sale / transfer into the Trust and be borne by the seller. Similarly on buy back. So, again it is crucial to consider sound advice before structuring such a transaction.

The other key consideration is how the benefits are structured that will be channeled to the employees via the trust. This will be considered hereunder.

**Income Tax for the Employee versus Dividends Tax**

Local dividends received and accrued to a South African taxpayer are exempt from normal tax in terms of section 10(1)(k) if the Income Tax Act, 1962 (“ITA”). One such exception applies to employee share schemes by virtue of the application of section 10(1)(k)(i)(dd).

Importantly, section 10(1)(k)(i)(dd) (introduced 1 January 2011), prescribes that a dividend will not be exempt from normal tax if such dividend is received or accrued in respect of a restricted equity instrument (as defined in section 8C), unless:

“`The restricted equity instrument constitutes an interest in a trust and, where that trust holds shares, all of those shares constitute equity shares, other than equity shares that would have constituted hybrid equity instruments as defined in section 8E but for the 3-year period required ....`”

According to SARS, the tests to be applied in each instance are as follows:¹

**First Test: the employee must hold ‘equity instrument’²**

**Second Test: the equity instrument must be acquired by virtue of employment³**

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² An equity instrument is widely defined in section 8C to mean a share in a company, including:
   - an option to acquire such a share or part of share;
   - any financial instrument that is convertible to a share; and any contractual right or obligation, the value of which is determined directly or indirectly with reference to a share.

³ An equity instrument must be acquired by virtue of employee’s employment. This means that there must be a direct or immediate link between the employment of the taxpayer and the acquisition that equity instrument. The fact that there is a relationship between the employment of the taxpayer and the acquisition of the equity instrument will not be sufficient, as the employment (and series rendered to the employer) must be the direct cause for acquisition of the equity instrument. In the absence of such direct, immediate and primary cause, the test would not be fulfilled.
Third Test: the equity instrument must be restricted

Fourth Test: The three exceptions: In order to escape a dividend being taxable as a restricted equity instrument (income tax liability), at least, one of the following three subtests must be fulfilled:

“Sub-test 1: In terms of this test, the restricted equity instrument must constitute an ‘equity share’. Therefore, if a shareholder’s right to dividends in respect of a share is restricted but that shareholder’s right to the capital is unrestricted, the share will not be an “equity share”.

Sub-test 2: In terms of this test, the dividend must constitute an equity instrument as defined in the first test.

Sub-test 3: In terms of this test, the restricted equity instrument must constitute an interest in a trust, and where that trust holds shares, all of those shares must constitute equity shares, other than equity share that would have constituted hybrid equity instruments as defined in section 8E but for the 3-year period requirement.”

Based on the Explanatory Memorandum of this section it seems that the dividend must be compensation for services rendered and, therefore, a disguised salary. Thus, put differently, where dividends are received and there is no motive to disguise such as remuneration, for example as a result of the shareholding only, the requirement will not be met.

Accordingly, only dividends tax at 15% is to be withheld at distributing the dividend.

However, according to a Binding Private Ruling issued by SARS, under BPR 209:

“The Applicant: A private company incorporated in and a resident of South Africa

The Co-Applicant: A Black Economic Empowerment trust (the BEE trust) established by the Applicant and a resident of South Africa

The Beneficiaries: Any black person (including any black person who is an employee of the Applicant or its subsidiaries), or groups of black people, whether or not they are employed by the Applicant or its subsidiaries.

The Co-Applicant, being a discretionary trust, was established by the Applicant to pursue Black Economic Empowerment initiatives through the provision of financial and other assistance to the

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4 An equity instrument becomes unrestricted when it ‘vests’ in a taxpayer for a purpose of section 8C of the ITA. AN unrestricted equity instruments is deemed to vest on the date that it is acquired by the taxpayer, whilst a restricted equity instrument is deemed to vest in a taxpayer when all the restrictions in respect of such equity instrument cease to have effect, or when the taxpayer disposes of such equity instrument, whichever is the earlier.


6 Date issued: 15/10/2015
Beneficiaries. The trustees are empowered to determine in any given year of assessment who the beneficiaries will be. They are not named in the trust deed.

The trustees are black persons employed by the Applicant or any of its subsidiaries, as well as independent trustees. Trustees may be beneficiaries of the trust.

The trustees may not make any distribution to beneficiary who is an employee unless (pursuant to a BEE initiative) its purpose is to incentivise that employee or to retain his or her services within the Applicant or its subsidiaries, provided that under no circumstances shall such distribution and benefits that such Beneficiary would otherwise have received in his or her capacity as an employee within the Applicant or its subsidiaries.

The Applicant intends to distribute dividends in cash to the Co-Applicant (the BEE trust), which will in turn distribute those dividends to its Beneficiaries.

The ruling made in connection with the proposed transaction is as follows:

(a) This ruling only applies to dividends to be distributed to the following Beneficiaries:
   (i) Black employees of the Applicant or its subsidiaries; and
   (ii) the trustees of the Co-Applicant, who are also black employees of the Applicant or its subsidiaries.

(b) The dividends to be received by the Beneficiaries mentioned in (a) above will not be exempt from normal tax, as section 10(1)(k)(i)(ii) will apply.

(c) The dividends to be distributed to the Beneficiaries mentioned in (a) above will be exempt from dividends tax under section 64F(1)(l).

(d) The Applicant will therefore not be required to withhold dividends tax, as contemplated in section 64G(2)(a), from the dividends to be paid to the Beneficiaries mention in (a) above, provided they have submitted their declaration and written undertakings, as contemplated in section 64G(2)(a), to the Applicant.

Accordingly, in my opinion, if any benefits are linked to an employee’s performance or is given with the intention or replacing his/her remuneration as employee – income tax will be payable. The exact extent and how this will be measured by SARS is still unclear.

Accordingly, circumventing the inclusion of dividend pay-outs as to be included in the income of the employee and thus subject to income tax and not dividends tax, is very challenging. Professional input and guidance is therefore non-negotiable.

Employees coming and going
Another important consideration to bear in mind is that BBBEE compliant employee share scheme benefits must vest in the employees. This principle becomes particularly challenging when we all know that employees come and go, and if said employee is a member of the BBBEE share scheme he or she will be entitled to a payout or distribution from the Trust which so vested, even when they are dismissed.

Although this cannot be completely avoided, one measure to mitigate this is to setup the trust in such a way that vesting to specific individuals happens periodically.

**Conclusion**

Setting up an employee share scheme is not a simple matter and should not be embarked upon without sufficient planning and sound advice.