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THE nature of share option schemes in South African companies will be transformed this year as new tax laws encourage broader equity ownership by employees, who are now able to acquire a potentially tax-free stake in their companies.

Amendments to the Income Tax Act herald the first tentative move on the part of the South African Revenue Service (SARS) to encourage the transfer of equity to previously disadvantaged individuals.

The changes, which came into effect on October 26 last year, provide for a fundamental change in the tax treatment of employee share incentive schemes.

Under the previous tax laws, any benefits arising from a share option were taxed. As a result, people tended to sell their shares, thereby forfeiting any long-term ownership of their companies.

Furthermore, issuing shares to employees at a reduced cost, or at no cost, tended to trigger fringe benefit tax, which many employees could not afford.

Some were inclined to sell their shares to pay the tax, which further discouraged ownership.

Under the new laws, employers are encouraged to set up a broad-based share scheme for the benefit of staff and to pass full equity shares to the participants.

Nadine Drutman, a director in tax and legal at accounting firm KPMG, says staff have nothing to lose in taking up the shares offered.

"Furthermore, the tax man is prepared to forgo the upfront tax on the free award - within certain parameters - and to allow the employee to deduct the main costs of the awards within certain limits", Drutman says.

A broad-based scheme is a share scheme that provides real access (with dividend and voting rights) to share capital for at least 90% of permanent staff who do not already participate in some other form of share scheme, says Drutman.

This means that shares could be distributed to 400 industrial workers if the proper controls are in place, which could be easily achieved, she says.

Drutman says this could benefit employers in different ways, such as in the form of a deductible expense, an empowered and motivated workforce, and possibly an empowerment rating enhancement, depending on the criteria used.

There is little downside to the company, Drutman says. "Obviously, set-up, administration, payroll and training costs will be there, but the scheme itself can be centrally controlled and managed."

A company's share option scheme should be housed in a trust with appropriate vesting mechanisms and appointed union-employer representatives.

Drutman says employees will have a potentially free grant of shares worth R9000 - taxable only at the time when they want to dispose of such shares, and then at the capital gains tax rate for individuals, after deducting the annual capital gains tax exemption.

Ian Wilson, a partner in corporate international tax at PricewaterhouseCoopers, says employees will benefit because the shares they receive are tax-free - "provided that they are held for a period of five years, and only then they will attract no more than capital gains tax".

Any gain from selling shares within the five-year period will be taxed as ordinary income, unless the disposal is part of a restructuring of the company and workers receive new shares in place of the original holdings, says Wilson.

Should this happen, the employee will be taken to have acquired the new shares at market value on the same date that they acquired the original shares.

Wilson says that restrictions on employees' rights to deal with the shares should be minimal.

However, he says the company may include restrictions such as the right of the organisation to reacquire the shares from the employee at their market value, and a restriction on disposal not exceeding five years.

The shares must be offered for a minimum consideration and the employees must acquire the full right of ownership, Wilson says.

Ernie Lai King, a director at Werksmans Tax, says the amendments change the tax dispensation relating to share incentive schemes "dramatically".

An added attraction of such schemes is that the market value, on grant date, of a share granted to an employee can be deducted from the company's tax liability, subject to a maximum of R3000 a year per staff member, says Lai King.

If the value exceeds R3000, the excess is carried forward for deduction by the employer in the next tax year for further qualifying shares granted to the employee during that tax year.

Wilson says that the new provisions are a clear invitation to companies to extend participation in equity to employees and give them the opportunity to benefit indirectly from the fortunes of the employer.

"Whether it will ultimately achieve the objective of giving employees a long-term stake in the economy remains to be seen," Wilson says.

