DIVIDENDS FROM EMPLOYEE TRUSTS

(DRAFT DATE: 3 AUGUST 2011)

[Applicable provision: Section 10(1)(k)(i)(dd)]

I. Background

A. Disposal or vesting of restricted share incentive schemes

Anti-avoidance rules exist to prevent taxpayers from disguising high-taxed salary through the use of restricted share (or share-based) incentive schemes that would otherwise trigger low-taxed (or even no-taxed) income or capital gains. These anti-avoidance rules essentially trigger ordinary revenue when these instruments are disposed of by employees (or fully vest for their benefit). The triggering events are designed to be delayed so that the appreciation associated with these schemes is fully taxed.

The anti-avoidance rules at issue technically apply to “restricted equity instruments.” The term equity instrument” is fairly expansive, including shares and share-based rights associated with shares. These share-based rights even include contractual rights or obligations, the value of which is determined directly or indirectly with reference to a share. In order for an equity instrument to be viewed as a restricted equity instrument, these equity instruments must contain one or more restrictions that mainly relate to the disposal or ownership of those instruments.

B. Dividends from share incentive schemes

In 2010, further amendments were added to prevent avoidance schemes stemming from the dividend aspect of restricted share (or share-based) incentive schemes. More specifically, dividends in respect of equity instruments will be treated as ordinary revenue unless the instruments constitute an equity share or the dividend itself constitutes an equity instrument. The purpose of these dividend rules is to prevent taxpayers from converting high-taxed salary into low (or no) taxed dividends. The schemes of concern relate to shares whose sole value relates to dividend rights held by employees (with the shares having little or no capital value once the dividend stream is complete).

II. Reasons for change

The newly added anti-avoidance rule of 2010 appears to be an effective regime for preventing the use of dividends from restricted shares (or share-based) incentive schemes as a mechanism to disguise salary. However, the new rule is seemingly overly broad, covering transactions never intended. Of particular concern is the holding of shares through employee trusts.

While employee trusts are a common source of mischief, many employee trusts exist simply as a matter of administrative convenience in order to simplify administration of widely-used employee shares. Some of these trusts contain restrictions so that the employees retain some interest in the employer for a meaningful duration. This form of restriction is common in the case of black economic empowerment. The net result is to impose ordinary revenue treatment in respect of dividends arising from almost all employee share trusts, even if no avoidance potential exists.

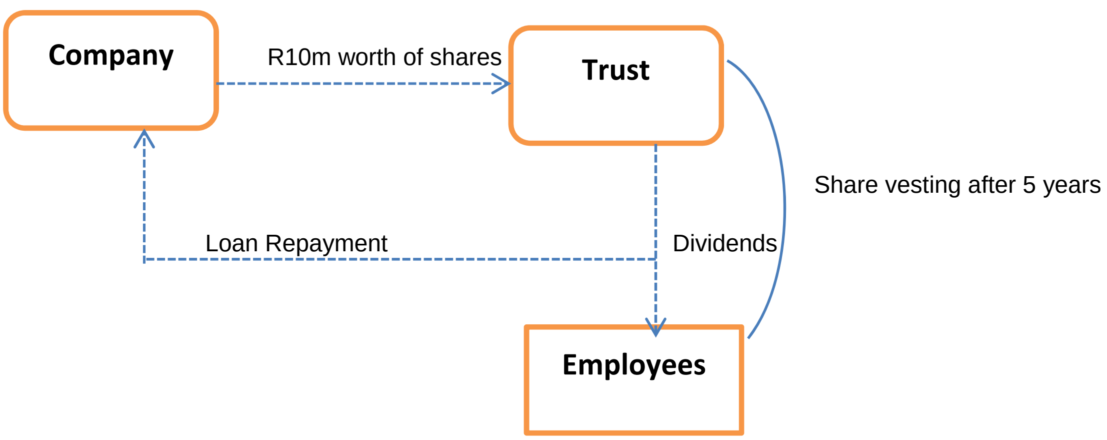
III. Proposal

The proposed legislation retains ordinary treatment for restricted equity share schemes as a general rule, but the revised legislation contains a carve-back. The purpose of the carve-back is to limit the new anti-avoidance rule without re-opening pre-existing avoidance.

More specifically, dividends arising from shares held in trust will fall within the carve-back (i.e. will retain their exemption from normal tax). If the sole assets of the trust must consist of pure ordinary shares (i.e. shares without a dividend or capital preference).

This change should effectively exclude preference shares tied directly or indirectly to key employee performance. Shares whose sole value stems from short-term dividends should be excluded because of the capital limitation.

EXAMPLE



Facts: Company creates an Employee Share Trust. Company lends R10 million to the trust. The trust acquires a specified number of ordinary shares in the company for the benefit of company employees. The shares in the trust will vest in the employees after a period of five years after taking into account the loan. Part of the dividends received by the trust in respect of the shares is used to repay the company loan, with the balance of the dividends paid to employees.

Result: The dividends received by the company on the loan amount as well as dividends received by employees are not impacted by the anti-avoidance rules (i.e. the dividends retain their exemption from normal tax). The non-application of the avoidance rule is based on the fact that the trust's sole assets are the company ordinary shares.

IV. Effective date

The proposed amendment will be effective as of 1 January 2011 in respect of dividends received or accrued on or after that date.