Long-term incentives

Some cross-border tax considerations

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Agenda

- Introduction
- Some Basics
- Long-Term Incentive Awards
- Applicable Tax Issues
- Section 10(1)(o)(ii)
- Conclusion
Introduction
Some Basics
Some basics ...

Tax residency

- “Residents”:
  - Subject to tax in South Africa on worldwide income
- “Non-residents”:
  - Liable for SA tax on SA source-based income
- Definition of resident:
  - Includes:
    - Ordinarily resident in South Africa
    - Resident ito physical presence test
  - Excludes:
    - Any person deemed to be exclusively resident of another country ito a Double Tax Agreement (“DTA”)
Some basics ...

Source of remuneration

- “Originating cause”:
  - Services rendered
- Location of originating cause
  - Where services are rendered
- Apportionment possible over earnings period
  - South African vs non-South African services
    - Work days vs calendar days
    - Nature of services
- Earnings period:
  - Eg. Bonus awarded in respect of a year, but may only receive if in employment one year later?
Long-term incentive awards
Why do companies have long-term incentive schemes?

Remuneration arrangements are generally representative of what the organisation values.

Remuneration is generally driven by the need to reward the right things to convey the right message about what is important.

Incentives generally aimed at matching the interests and objectives of the organisation with the interests and objectives of the employees.
Salary

Salary is often viewed as the element of remuneration received just for ‘doing the job’ with other elements rewarding performance.

Appropriate salary levels are essential for attracting and retaining highly skilled staff.
Annual bonus is an essential element of short-term remuneration that provides immediate reward for achievement of targets.

Motivational due to element of risk (not received if targets not met).

Often aligned to personal objectives.
Equity and other long-term incentive schemes

Why do companies use them as part of their remuneration strategy?

- Alignment of reward with the creation of shareholder value
- Attract and retain highly skilled staff in competitive markets
- Encouraging & rewarding certain behaviours
- Forging or reinforcing a common culture
Equity and other long-term incentive schemes cont.

In any form (nearly) imaginable

- Long term bonus plans
- Share option plans
- Restricted stock units
- Phantom schemes
- Deferred delivery schemes
- Vanilla option schemes
- Share appreciation rights
- Share purchase schemes

Be aware that any benefit from any of these schemes is probably taxable.
Equity and other long-term incentive schemes cont.

Performance Shares (1)

- Participants are typically given a right to receive shares at the end of a performance period at no cost
- Various Names for Similar Plans
  - Long Term Incentive Plan (“LTIP”)  
  - Free Share Plan  
  - Performance Shares  
  - Conditional Shares  
  - Contingent Share Awards  
  - Restricted Stock Units (“RSU”)

Does anyone of these sound familiar?
Equity and other long-term incentive schemes cont.

Performance Shares (2)

• Receipt of shares is generally conditional on:
  • Continued employment and/ or
  • Performance conditions
• Cash settlement often possible
• Dividend equivalents possible
• Usual tax treatment:
  • The point at which the shares “vest”
  • Vesting usually takes place at the end of the “performance period”
• Rules may vary from country to country
Equity and other long-term incentive schemes cont.

Restricted Shares (1)

- Employees are awarded shares and own those shares from the date of award, but they are subject to one or more restrictions which reduce the value of the shares
- Examples of restrictions
  - forfeiture for less than market value
  - sale restrictions
  - performance conditions
  - Board Directors’ power to veto the transfer of shares
- Typically, the employee has dividend and voting rights from the date of award
Equity and other long-term incentive schemes cont.

Restricted Shares (2)

- Generally, an income tax charge arises at all of the following points:
  - On acquisition
  - If restrictions are varied
  - If restrictions are lifted
  - If securities are sold
Employees are awarded a “right” (but not an obligation) to acquire a share in the future at a price which is set when the award is made.

The price payable in the future is the “exercise price”.

Share options can be:
- Market value options
- Discounted

Options were formerly the most common type of long term incentive but now used to a lesser extent - mainly as a result of market movements and the option expensing rules introduced under IFRS 2.
Equity and other long-term incentive schemes cont.

Share Options (2)

• Income tax is due at exercise on the difference between the market value of the shares at exercise and the exercise price paid
• Rules may vary from country to country
  • For example - South Africa:
    • Options granted prior to 26 October 2004 taxed at exercise
    • Options granted from 26 October 2004 taxed at vesting
  • For example – Belgium
    • Options taxed at grant – statutory prescribed formula
Equity and other long-term incentive schemes cont.

Phantom share schemes

- Employees are granted rights or units
- The value of these rights or units are determined with reference to the share price
- On vesting, a cash payment is made to the employee
- Typical Tax Treatment:
  - Taxed as bonus (but similarly to equity incentives in South Africa from 21 October 2008)
  - Rules may vary from country to country
Equity and other long-term incentive schemes – applicable tax provisions

- Paragraph (i) of definition of “gross income” – section 1
- Sections 8A, 8B & 8C
- Section 10(1)(o)(ii)
- Paragraphs 1 (definition of “remuneration”) & 11A of 4th Schedule
- Sections 10(1)(nC), 10(1)(nD), 10(1)(nE)
- Paragraphs 11(2)(a), 11(2)(j) & 11(2)(k) of the 8th Schedule
- Paragraphs 20(1)(g)(iii), (20(1)(h) & 58 of 8th Schedule
- Paragraphs 12(2)(a)(ii), 12(2)(a)(iii) & 12(2)(a)(iv) of the 8th Schedule
Equity and other long-term incentive schemes cont.

The bottom line

- Remuneration in any form is generally taxable in South Africa.
- Remuneration includes equity gains.
- The appropriate portion of the equity gain is taxable in South Africa.
- How do we get to the bottom line?
Equity and other long-term incentive schemes cont.

How do you determine taxable gains

- Right to acquire marketable security obtained before 26/10/2004 - at exercise (section 8A)
- Equity share acquired in terms of broad based employee share plan – sale of shares within 5 years (section 8B)
- Equity instrument acquired from 26/10/2004 - at vesting (section 8C)
Equity and other long-term incentive schemes cont.

**Section 8C**

- Gain / loss on **vesting** of equity instrument (s8C(1))
- Prior to vesting – exempt (section 10(1)(nD))
- Acquired by taxpayer (on / after 26 October 2004) by virtue of employment / office of director or from any person by arrangement with the taxpayer’s employer (causal link = NB)
- Equity instrument (s8C(7))
  - Share / part of a share / member’s interest
  - Option to acquire share / member’s interest
  - Financial instrument convertible to share / member’s interest
  - Any contractual right / obligation – value determined directly / indirectly with reference to share / member’s interest (i.e., equity instruments acquired after 21 October 2008)
Equity and other long-term incentive schemes cont.

Section 8C cont.

- Restricted equity instrument (section 8C(7))
  - Cannot freely disposed of at market value
  - Restriction could result in –
    - forfeiture at less than market value
    - taxpayer penalised financially of not compliant with terms of agreement for acquisition
  - Right to impose two above-mentioned restrictions
  - Option only convertible to a restricted equity instrument
  - Financial instrument convertible into restricted equity instruments
  - “Employee escape clauses”, e.g. “stop-loss provision”
  - Not deliverable until happening of (fixed / contingent) event
Equity and other long-term incentive schemes cont.

Section 8C cont.

- Unrestricted equity instrument – vesting: Acquisition
- Restricted equity instrument – vesting:
  - When all restrictions causing “restricted equity instrument” status are lifted, i.e. when the equity instrument is no longer a “restricted equity instrument”
  - Immediately before the employee disposes of the instrument
  - Immediately after an option terminates
  - Immediately before the employee dies (if restrictions lifted after death)
Equity and other long-term incentive schemes cont.

- Options – vesting
- SARS binding private ruling (BPR 021 dated 14 July 2008)
- Rules of scheme provided, inter alia, for the following:
  - The options are personal and only capable of being exercised by the option holder to whom the option was granted
  - The option holder may not alienate or encumber any of the options
  - The options are exercisable after expiry of certain minimum periods
  - Exercise of an option was only completed once certain requirements, eg. completion of certain documentation and payment of the option price in full.
Equity and other long-term incentive schemes cont.

**Section 8C cont.**

- BPR 021 issued:
  - Option remain a “restricted equity instrument” until –
    - the minimum periods have passed;
    - the option has been exercised; and
    - the option price has been paid.
  - Until the abovementioned requirements have been satisfied, the options remain “restricted equity instruments” and accordingly, pursuant to section 8C(3)(b) of the Act, have not vested despite the minimum periods stipulated have expired.
• Gain: Equity instrument exchange / scheme cancelled (s8C(2) & (5)(c)) – amount received / accrued less consideration
• Gain: Other - MV on vesting less consideration (s8C(2(iii))
• MV (s8C(7)):
  • Arm’s length price on open market (as if share unrestricted)
  • Private company: Valuation method
• “Anti-avoidance provision” (s8C(5))
  • Eg. cession to connected party / non-arm’s length transaction
• Gain / loss taxable in hands of employee / director
• Roll-over relief (s8C(4))
Equity and other long-term incentive schemes cont.

Section 8C cont.

- CGT considerations
  - Base cost = MV on vesting (par 20(1)(h))
  - Interest on borrowings – listed shares (par 20(1)(g)(iii))
  - On exercise of option no gain / loss (par 58 of 8th Schedule)
  - Residence ceasing (par 11(2)(j) & 12(2)(iii) of 8th Schedule)
Challenging factors
What keeps you awake at night?

- Fluctuating share prices
- Tracking a mobile workforce
- Services rendered across borders
- International share schemes
- Shares granted for past services.
Expatriates often say ...

“I was granted the options before I set foot in South Africa, I should not have to pay tax on the gain in South Africa!”

“These shares vested when I was working in Dubai!”
The reality is ...

If any services were rendered in South Africa over earnings period - SARS will tax the South African sourced portion of the share again
A small detour

OECD Model Convention

- Mobile Employee/Cross Border Calculations - questions to consider:
  - Where is tax payable?
  - When is tax payable?
  - How much should be subject to tax?
  - What about double taxation?
  - Where is social security payable?
  - Does it matter if the costs of the options are recharged?
  - What withholding and reporting obligations does the employer have in each location?
  - What reporting obligations does the employee have in each location?
A small detour (... and it is bumpy!)

1. Grant
2. Vest
3. Deemed Exercise
4. Exercise
5. Sale

Stock Options

- Belgium
- Czech Republic
- Singapore
- Germany
- Chile
Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived there from may be taxed in that other State.

Applicable, irrespective of qualification or nature of taxation as capital gain in domestic country, such as:
- France: if qualified regime and holding period satisfied
- Italy: if favourable conditions are met
- ISO (US)
- Approved option (UK)

Because it is a benefit granted, linked to employment.
Employment income is defined only as that realized up to share acquisition (that is, option exercise).

Once the employee becomes a shareholder, any further income / loss is from personal investment. Capital gains are excluded from Article 15.
A small detour (... with some road signs!)

![Graph showing value of shares over time with vesting, exercise, and sale milestones.

- **Value of the share (FMV)**
  - 2006: 90
  - 2007: 100
  - 2008: 110
  - 2009: 120
  - 2010: 130
  - 2011: 140

- **Article 15**

- **Capital Gain** = \(135 - 120 = 15\)
A small detour (... with some road signs!)

Article 15 of OECD Model Convention

- How to calculate sourcing of stock option income? To what services does the income relate?
  - Depends on facts and circumstances
  - General rule: stock option income relates to “future services” (i.e. after grant)
  - Relates to activity between grant and vesting (not grant to exercise)
A small detour (... with some road signs!)

Article 15 of OECD Model Convention

- It is not so simple!
- Remaining issues
  - Timing of taxation/sale (France) vs. exercise (US)
  - Social security
  - “New” sourcing rule is not applicable everywhere yet
  - In some countries, no sourcing rules apply
  - Grant – vesting rules will multiply by three or four the number of calculations per transaction since usually there is a sliding vesting schedule: 1/3, 1/3, 1/3 each year!
What is taxable in South Africa?
A reminder ...

South African tax residents

- Taxed on worldwide income - may qualify for a s10(1)(o)(ii) exemption or s6(quot) rebate
- Remember paragraph (C) of proviso to section 10(1)(o)(ii)

Non-residents

- Taxed on South African sourced income
Section 10(1)(o)(ii) of the Act provides relief for SA residents who render services outside SA.

Exempts from tax in SA, remuneration received in respect of services rendered outside SA for or on behalf of **any** employer if the following 3 requirements are met:

- The individual should be outside SA for a period / periods exceeding **183 full days** in aggregate during any 12 month period; and
- The individual should be outside SA for a continuous period exceeding **60 full days** during that period; and
- The services should be rendered whilst the individual is outside SA during the 12 month period.
South African tax residents

- Income not considered remuneration:
  Restraint of trade payment, gratuity, retrenchment.
- Proviso (C) to section 10(1)(o)(ii) (included by the Revenue Laws Amendment Act, 2007):
  “(C) for the purposes of this subparagraph where remuneration is received by or accrues to any person during any year of assessment in respect of services rendered by that person in more than one year of assessment, the remuneration is deemed to have accrued evenly over the period that those services were rendered.”
South African tax residents

What if the SA employee does not meet the s10(1)(o)(ii) criteria?

• Double taxation – taxed in source country on source and in SA on a worldwide basis.
• Section 6quat – rebate in respect of foreign taxes on income.
Suggested approach:
- Determine bonus / gain (latter on “vesting”)
- Apportion bonus / gain over the period over which the performance of the employee is measured. Section 8C gains should be evenly apportioned over the period from the date of grant until the vesting date of the equity instruments concerned. Perhaps let us call this “the accruing period”.
- Allocate the bonus / gain between the various tax years over which the accruing period spans.
- Allocate the portion of the bonus / gain that relates to a specific tax year between local and offshore services - use same basis as used for the employee’s other remuneration.
South African tax residents

What if the SA employee meets the s10(1)(o)(ii) criteria?

- The offshore portion of the bonus / gain will be exempt from South African taxation if the services rendered offshore fell within a 12 month period (as discussed above) that either ended or started in the tax year concerned and during that 12 month period the employee met the 183/60-day requirement.
Non-residents

Determination of source

- Suggested approach:
  - Determine bonus / gain (latter on “vesting”)
  - Apportion bonus / gain over the period over the “the accruing period”.
  - Allocate the bonus / gain between the various tax years over which the accruing period spans.
  - Allocate the portion of the bonus / gain that relates to a specific tax year between local and offshore services - use same basis as used for the employee’s other remuneration. The offshore portion of the bonus / gain will be exempt from South African tax.
Draft Binding Private Ruling:

“The South African resident employees will be exempted from income tax to the extent that section 10(1)(o)(ii)(C) applies and the gain under either of the schemes spans a period where the said section applies. Remuneration which is received by or that accrues to any South African resident employee during any year of assessment in respect of services rendered by that employee in more than one year of assessment is deemed to have accrued evenly over the period where those services were rendered.”
Expressed as a formula in cases where section 8A / 8C applies, this would be:

\[
\text{S8A/8C gain} \times \frac{\text{Total Calendar Days between Date of Grant and Date of exercise}}{\text{Total Calendar Days outside South Africa}} = \text{Exempt portion under section 10(1)(o)(ii) and in the year of the section 8A /8C event}
\]
Questions