

# New amendments deal with incentive schemes

**NEW** amendments have been proposed to the Income Tax Act dealing with incentive payments to employees.

The first relates to where an incentive payment or a retention bonus is paid to an employee on the basis that the amount is to be repaid if certain conditions are met. Other amendments relate to share incentive schemes.

The first proposed amendment dealing with repayable employee benefits is aimed at removing the inequity that arises if an employee has to repay an amount received from his employer. For instance, if X receives R1 000 on condition that he has to repay the R1 000 if he for any reason ceases to be employed by his employer within a period of two years, he would on day one only receive R600 net of tax given the fact that the R1 000 would be subject to pay-as-you-earn (PAYE) tax at the rate of 14% (assuming the marginal tax rate). In other words, he would only be receiving R600 in his pocket on day one. However, the commercial agreement is that he must repay R1 000 if he resigns within the two year period. In the absence of any legislative change, the employee would not have been able to claim a deduction of the R1 000 that is repaid. There would also not have been a refund of any PAYE that has been withheld by the employer in



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respect of the R400 that has been withheld in the form of PAYE.

It is now proposed that the R1 000 will be allowed as a deduction against the taxable income of X. To the extent that X does not have sufficient taxable income, an assessed loss is created and carried forward to the succeeding year of assessment. A deduction of the repaid benefit will also be allowed against the amount on which the PAYE is required to be calculated.

However, it is appreciated that the proposals do not trigger a PAYE refund from the South African Revenue Service (SARS) if the amount is repaid. A refund will be made on the assessment of X after he has submitted his income tax return. The deduction will be allowed for all salary related funds that are returned to employers.

Even though there is a deduction of the R1 000 for X whenever he has to repay the amount, it would still result in a cash flow squeeze as the refund is only to be allowed after his assessment by SARS.

Bonuses are often paid to employees as a manner of incentivising them and to provide for a retention mechanism. In other words, if an employee resigns within a stipulated period, the bonus has to be repaid. The negative tax consequences resulted in these type of transactions being effective to retain employees as they would not have been able to fund the amount that has to be repaid to the employer to the extent applicable. The mobility of employees is to some extent restored by these proposed amendments.

In a more significant amendment, the provisions of the Income Tax Act dealing with share incentive schemes are to be amended. The effect is that most phantom schemes and so-called share appreciation right schemes will also now be covered by the principle that an employee will have to account for income tax on the difference between the market value of his contractual right and whatever he pays for such right. The payment would be calculated at the income tax rate of the employee and not as a capital gain because a financial instrument is defined as

a contractual right the value of which is determined directly or indirectly with reference to a share. In other words, the fact that an employee will only receive the share or a cash payment equal to the value of the difference in share movements, would not impede upon the fact that such amount would be subject to income tax.

Given the fact that these type of payments would generally have constituted a bonus, the effect upon the employee is not so much as the payment is still subject to a rate of 40% whether the benefit is received by the employee in the form of cash or in the form of shares. The consequence, however, is that all of the provisions of the Income Tax Act dealing with share incentive schemes will now also govern the phantom schemes and share appreciation right schemes. Employers will have to take great care when implementing these schemes.

In a similar vein the definition of a restricted equity instrument in the context of these share incentive schemes will be amended. The general principle is that the tax liability arises whenever equity instruments become unrestricted (which will now also include phantom schemes and share appreciation right schemes). The question is when will such an equity instrument become unrestricted. Previ-

ously, a restriction related to the situation where employees could forfeit shares at less than market value or related to the position where an employee could not sell his shares within a certain period.

However, a restriction did not extend to a scenario where an employee would have been penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of the equity instrument. For instance, a transaction could be structured in such a manner that there are no restrictions on the disposal of the shares.

However, if an employee resigns, he would have had to pay a penalty of, say, an amount equal to the market value of the equity instrument or shares to the employer. In other words, the employee would still have been financially prejudiced even though the shares in themselves would have been restricted. The definition of a restricted equity instrument will now be extended so as to include these type of situations where the employee would be penalised financially in any other manner (but in terms of the same agreement) if the related terms of acquiring the equity instrument have not been complied with.

■ *Emil Brincker is a director at Edward Nathan Sonnenbergs.*