DAVEY'S Locker

TAX SHOCK, HORROR NEWSLETTER

February 2014

Employee share trusts

Dividends now tax-inefficient

by Tony Davey

Consequent upon amendments to tax legislation effective as from 1 March 2014 the tax treatment of dividends received by an employee share trust that are distributed in turn to participating employees will change in many instances.

The current position
Dividends are exempt from normal income tax but are subject to a final withholding dividend tax at the rate of 15%.

It follows that dividends received by an employee share trust that are in turn distributed to employees currently incur a 15% tax charge only.

From the relevant *Explanatory Memorandum*

> According to policy, if an employer pays an employee for services rendered, the amount should be included in gross income and taxed at marginal rates irrespective of how the employer funded the payment. Furthermore, the same tax consequences should flow irrespective of whether the payment was made directly or indirectly by the employer to the employee (eg facilitated through an employee share trust).
>
> However, many share schemes hold pure equity shares where the sole intent of the scheme is to generate dividends for employees as compensation for past or future services rendered to the employer, without the employees over obtaining ownership of the shares. The dividend yield in these instances effectively operates as disguised salary for employees (that is not deductible by employers) even though these dividends arise from equity shares.

Tax amendments
Courtesy of an additional subparagraph inserted into the proviso of s 10(1)(*k*)(i), a dividend received by an employee via a trust under an employee-share scheme is removed from the dividend exemption provided by s 10(l)(*k*)(i) and hence is fully taxable, unless the employee either directly holds the share or the share trust is of a s 8C restricted-equity-instrument type.

Any non-exempt dividend received by an employee via a trust will be fully taxable as normal income at each employee's marginal rate of tax.

The responsibility to declare such income in his or her tax returns lies with each employee, who will also have to register as a provisional taxpayer.

Application to an employee-share trust

Other than shares held directly by employees, only s 8C share-trust restricted-equity schemes qualify for the final withholding 15% tax charge. Section 8C-restricted equity schemes are basically in the nature of share option schemes, under which participating employees acquire a right to purchase an equity instrument at a future date at the current price prevailing at the date of acceptance of the option right.

If a trust is not a s 8C trust, the trustees should make a declaration to the company not to withhold the dividend tax of 15% on dividends that are to be distributed to participating employees, since normal tax will be payable by employees.

Observations

This new arrangement is tax-inefficient for an employer, since a dividend is paid out of after-tax monies. Maybe an exempt threshold should have been introduced to accommodate low-income-earning employees.

Stop press

A significant change in the latest Budget is the R185 000 increase in the tax exemption upon retirement, death or retrenchment, with the threshold increase from R315 000 to R500 000, together with a consequent increase for each subsequent tax-bracket threshold. *tsh*