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Spur judgment: Impact on employer-funded share incentive schemes

By Michael Rudnicki and Samir Ellary

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Much has been written about the judgment made in *Commissioner for Sars v Spur Group (Pty) Ltd [15 October 2021]* in the past few weeks. Two salient themes emanate from it, the:

- question about why employer funding costs would not qualify for tax deductions; and
- learning that tax returns disclosure must be meticulously considered and reviewed prior to Sars filing.

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Background

Spur Corporation Ltd (Spur HoldCo) is the holding company and 100% shareholder of Spur Group (Pty) Ltd (Spur). Spur is the main operating entity in the Spur Group.

In 2004, the Spur Group resolved to implement a new share incentive scheme (scheme), in terms of which eligible employees of Spur (participants) were afforded the opportunity of participating in the future growth of the group.

In the same year, Spur HoldCo established the Spur Management Share Trust (Trust) in terms of which Spur HoldCo was the sole capital and income beneficiary. The Trust incorporated a new company, NewCo, and the participants of the scheme were invited to acquire shares in NewCo.

Spur contributed approximately R48m to the Trust which was used to invest in preference shares in Newco, generating a market-related return. The funds invested in NewCo were used to acquire shares in Spur Holdco. Participants acquired ordinary shares in Newco. The value of their shares was referenced to the growth of the ordinary shares over and above the value of the preference shares owned by the Trust.

As vested capital and income beneficiary of the Trust, Spur Holdco would benefit from the preference shares and their return. Accordingly, employees bore no risk in relation to their shares given their nominal value.

Disputed deduction: The contribution was not incurred in the production of income

Spur claimed the contribution as a deduction under the 'general deduction formula' which is premised on a number of rules, but of particular relevance to this matter is that the expenditure must be incurred in the production of income.

For a deduction to be claimed under this rule, judicial precedent has previously held that the purpose of the expenditure must have been to produce income; and there must be a sufficiently close nexus or link between the expenditure and the ultimate production of income.

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While the deduction was originally allowed by Sars, it was disallowed in an additional assessment on the basis that there was no direct, causal link between the contribution and the production of Spur's income.

Sars argued that the participants were not the beneficiaries of the contribution as Spur HoldCo was the only party to have benefitted *directly* from the contribution, namely beneficial entitlement to the preference share capital and its return.

In other words, the link between the expenditure and any benefit arising from the incentivisation of Spur's key staff was insufficient. '…the purpose of Spur incurring the expenditure was not to produce income … but to provide funding for the scheme, for the ultimate benefit of Spur Holdco'.

It is respectfully considered that the contribution was at least incurred with a dual purpose. Why else would Spur have contributed R48m? Merely to benefit from a prime rate related return?

In fact, even though the judgment suggests that the contribution will ultimately accrue to Spur Holdco, the position could have been very different if the share price had decreased from the date of the contribution.

Take away

Whilst a number of commentators have indicated that this judgment could spell the end of share schemes funded by employer contributions, it should be noted that the facts in this instance were quite specific, and not all employer contributions to employee share schemes are structured in the same manner.

In fact, Sars has issued a few binding private rulings in favour of the taxpayer allowing the deduction by the employer of such contributions to employee share scheme trusts (where the employees are vested income and capital beneficiaries), subject to an appropriate apportionment, where applicable.

These contributions are often key in these types of employee share schemes where there are valid commercial reasons/grounds (for eg. B-BBEE purposes) to ensure that the shares held by the employee trust are not entirely funded – ie. the employee beneficiaries have some immediate ‘skin in the game’ in the underlying shares from day one.

Be that as it may, given the high profile of the case, it would be prudent for schemes funded with contributions to be re-examined to ensure that the principles underpinning the contributions are still sound from a tax perspective

Misrepresentation: What is the impact of incorrect disclosure and/or non-disclosure?

The income tax return filed by Spur contained three important questions:

1. whether there were deductions limited in terms of section 23H;
2. whether the company made a contribution to a trust; and
3. whether the company was party to the formation of a trust during the year.

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While all of the events happened in 2004, Spur answered no to all of the above questions in its 2005 tax return. Similarly, in its 2006 tax return, Spur declared that no deductions were limited in terms of section 23H, when there had in fact been limited deductions. Finally, in each of the 2005 to 2008 income tax returns, the amount of deductions claimed in respect of the contribution, which were limited, were not disclosed under the correct section of the tax return.

While Spur argued that this was merely negligent, the Court found that the incorrect disclosures were plainly false and amounted to deliberate misrepresentation and non-disclosure. This was especially so since the error was repeated in tax returns over multiple years.

Spur attempted to explain the error by stating that there was a new accountant who was not fully appraised of the details of the scheme. However, the Court noted that a public officer is required to make a declaration that the information and particulars furnished in the return are true and correct. This cannot be a mere “rubber-stamping” exercise, and it is a serious offence to make a false declaration.

The fact that an auditor/assessor could have ascertained the correct information (eg. from financial statements) is not a defence to misrepresentation nor does it absolve the taxpayer of its misrepresentation.

The implication of the misrepresentation extends further than any relevant monetary penalties; it eliminates the protection of prescription thus allowing Sars to make historic assessments dating as far back as they believe the full amount of tax chargeable was not assessed.

Take away

The case highlights the importance in accuracy when disclosure and answering questions in the tax return. The provision of inaccurate information or answering questions incorrectly, however so innocent, is likely to cause Sars to invoke its legislated power to ameliorate prescription.

ABOUT THE AUTHOR

Michael Rudnicki, executive, and Samir Ellary, partner, Bowmans South Africa