Dear Sir/Madam

CALL FOR COMMENT: INTERPRETATION NOTE 17 EMPLOYEES’ TAX: INDEPENDENT CONTRACTORS “(INTERPRETATION NOTE)”

We refer to your call for comment regarding the above-mentioned document that was placed on your website. Set out below please find SAICA’s comments, which have been provided by members of our National Tax Committee:

1. Heading

1.1 The heading of the draft Interpretation Note reads “issue 2”. This appears to be incorrect as the previous version of the Interpretation Note issued on 9 January 2008 was issue 2. The latest version of the Interpretation note should therefore be “issue 3”.

2. Background

2.1 It is suggested that all Interpretation Notes should follow the same structure. For example Interpretation Note 35 reproduces in point 3, the relevant legislation, which is helpful. This point is however missing from Interpretation Note 17.

2.2 In paragraph 2 the Interpretation Note advises as follows: “In determining whether or not a person must be regarded as an independent contractor, the statutory tests are in practice considered first. If the statutory tests are not applicable in a particular situation, the common law tests are applied to finally determine whether the person is an independent contractor or an employee.” In our view this appears to be incorrect.

2.3 The common law test is to be applied first, and:
- should a person be found to be an employee in terms thereof, no further investigation is required, and remuneration paid to such person will not fall within the exclusionary subparagraph (ii) of the definition of “remuneration”; however
- should a person be found to be carrying on a trade independently in terms of the common law test, further investigation is required in order to establish whether, notwithstanding the fact that the person is independent in common law, the statutory test would apply. Should the statutory test apply positively, a person who is independent in common law will be deemed not be carrying on a trade independently, and remuneration paid to such person will not fall within the exclusionary subparagraph (ii).

In conclusion, the common law test is to be applied first and the statutory test thereafter, for the purpose of determining whether amounts paid constitute “remuneration”, as defined.

3. **Paragraph 3**

3.1 Paragraph 3 states that there are two instances where it has to be determined whether a person is an employee as opposed to an independent contractor, i.e. the exclusionary paragraph to the definition of remuneration and whether a labour broker is conducting an independent trade. We suggest that a third instance, i.e. the application of paragraph (a) of the definition of personal service provider, be added.

3.2 In paragraph 3.1 of the Interpretation Note, under the heading: “Exclusionary subparagraph (ii) of the definition of the term ‘remuneration’”, the Interpretation Note states as follows: “The exclusion would therefore in general only be applicable to natural persons or trusts (excluding personal service trusts)”. The definition of “personal service trusts” has been removed from the Fourth Schedule. It is therefore, recommended that this sentence be amended to read as follows: “The exclusion would therefore in general only be applicable to natural persons or trusts (excluding trusts which qualify under the definition of “personal service provider” in paragraph 1 of the Fourth Schedule)”.

4. **Paragraph 4**

4.1 In paragraph 4 of the Interpretation Note it is stated that a SARS branch office is not permitted to consider applications from persons apparently falling into paragraph (a) of the definition of “employee” in the Fourth Schedule. The onus is therefore on the employer to do the independent contractor classification.

4.2 It is also then stated that the employer could be liable for the employees’ tax not deducted as well as penalties and interest on these amounts. This is also stated in the example later in Annexure E (i.e. that the employer could be held liable for these amounts).

4.3 The practical problem with this system is that employers are basically in a “no-win” situation, because they gain nothing by classifying a taxpayer as an independent contractor and not deducting any employee tax, but there is a huge risk in classifying a taxpayer as an independent contractor. As stated above an incorrect classification could have serious financial consequences for the employer.
4.4 In practice, it therefore appears that employers in an attempt to avoid any risk, do not properly apply the independent contractor tests as set out in the Interpretation Note but rather deduct employee’s tax as a general rule.

4.5 It appears that there is no remedy for taxpayers who have been incorrectly classified as employees (not as independent contractors) to rectify such incorrect classification, and preventing employees’ tax from being incorrectly deducted.

4.6 In terms of section 76Q of the Income Tax Act employers would also not be allowed to apply for a ruling regarding the independent contractor status of a taxpayer, as this could have potentially assisted employers.

4.7 In light of the above risk to employers, the degree of subjectivity applicable to the tests involved, as well as the fact that the advance tax ruling system is not available, results in taxpayer’s potentially being left at the mercy of employers to correctly apply the independent contractor criteria and assume some of the risk.

4.8 It is therefore respectfully requested that taxpayers either be able to approach SARS to assist them in making the independent contractor classification or a system be put in place that will enable taxpayers to raise an objection to SARS where employers have according to them incorrectly classified them as not being independent contractors.

4.9 Paragraph 4 of the Interpretation Note, in the last subparagraph states that the employer will be liable for PAYE, interest and penalties if an incorrect assessment has been made as to whether a person is an employee or independent contractor. It is suggested to give a balanced view, the Interpretation Note should mention paragraph 5(2) of the Fourth Schedule.

5. **Paragraph 5**

5.1 In the application of the statutory test, it is correctly stated that a taxpayer who employs three or more unconnected employees throughout the year of assessment, will be deemed to be carrying on a trade independently.

5.2 However, it does not appear that the Interpretation Note addresses this exclusion in relation to the application of the common law test, as per the wording of the Act, this exclusion also appears to apply to the common law test. For example, if a taxpayer employs three or more unconnected employees throughout the year of assessment, neither the statutory test nor the common law test will apply to such a taxpayer, and this taxpayer will be deemed to be an independent contractor by reason of the three or more independent employees’ exclusion. We suggest that the Interpretation Note be amended to clarify this.

5.3 In light of the discussion in paragraph 5.2 above, it is also suggested that the flow diagram in “Annexure A” be amended to incorporate the three or more unconnected employees’ exclusion in the type (a) employee column on the far left of the flow diagram. We propose that after the question, “Is person a resident in RSA?” a new question be added, asking if the taxpayer employed three or more unconnected employees throughout the year of assessment. If answered in the positive, then such a taxpayer should not be subject to employee’s tax.
5.4 It is requested that the Interpretation Note provide guidance to employers in the practical application of the three or more unconnected employees’ exclusion. Such guidance is needed as employers do not have access to the records of potential independent contractors to ascertain if they employ three or more unconnected employees throughout the year of assessment. It is therefore requested that the Interpretation Note allow employers to in good faith rely on an affidavit made by a potential independent contractor stating that such independent contractor employs three or more unconnected employees throughout the year of assessment.

5.5 We request that paragraph 5 of the Interpretation Note should give guidance on the application of paragraph (ii) of the exclusion to the definition of remuneration. The problem can be illustrated by the following example:

Dr. X has a practice in town where he spends 50 hours a week seeing patients. He also has a contract with a factory in terms of which Dr. X attends their on-site clinic every Tuesday and Thursday from 09:00 to 12:00 (i.e. control over hours of work).

Will Dr. X be excluded from being an independent contractor based on the fact that he has to perform the duties in terms of the contract exclusively at the premises of the client (the clinic) or will he be excluded from the definition because he spends only 6 hours of the 50 hours per week that he works at the premises of the client (therefore not "mainly")?

It is not clear whether the services that need to be considered relate to all his services of the services rendered in relation to one client.

5.6 In light of the practical problem as illustrated in paragraph 5.5 above, it is suggested that subparagraph 4 of paragraph 5 of the Interpretation Note should read as follow: “It is therefore not necessary for both tests to be applicable in a particular situation. The application of only one of them would trigger the deeming provision. It should be noted that neither of these tests are applicable if the services are not required to be provided mainly (i.e. more than 50%) at the premises of the client.”

6. Paragraph 6

6.1 The example in paragraph 6 of the Interpretation Note essentially states that the contractor is dependent in terms of the statutory test and independent in terms of the common law test. However, paragraph 5 states that "where any of these tests (i.e. statutory tests) apply positively, it is not necessary to consult the common law dominant impression test". The example appears not to be in line with the Interpretation Note, as the example implies that both tests need to be applied to determine a contractor's status.

6.2 It is suggested that the example be adjusted to reflect SARS' intention, i.e. either of the following:- Whether the common law test should be applied to determine the coding of the contractors income on IRP 5's irrespective of whether the statutory test applies positively; or- Whether, in the event of a contractor where
the statutory test applied positively (i.e. the contractor is dependent) it should be
coded as 3601 and where the contractor failed the statutory test, but the common
law test applied positively the income should be coded as 3616.

6.3 A further practical problem appears to be whether a common law independent
contractor, but due to the application of the statutory test is not considered to be
an independent contractor, could receive a travel allowance as contemplated in
section 8(1) of the Income Tax Act? It is requested that the Interpretation Note
gives practical guidance in this regard.

7. **Paragraph 8**

7.1 The last subparagraph of paragraph 8 of the Interpretation Note states that “The
client and the worker (or business) must be required to provide a detailed
motivation (preferably an affidavit) as to why any particular indicator does not
indicate what it apparently does”.

7.2 It may not be practical for an employer to keep detailed affidavits for every
independent contractor whose services it engage. Most organisations require the
individual to complete a questionnaire to test the independent status of the person,
in addition to the contract of engagement.

7.3 It also does not appear to be clear whether this comment relates to documentation
that needs to be retained ordinarily or relevant for SARS officials as part of an
investigation.

7.4 Paragraph 8 of the Interpretation Note, the third bullet point reads as follows:
“resonant of either an employee/employer relationship or an independent
contractor/client relationship, which are relevant.” For the sake of clarity it is
recommended that this be amended to read as follows: “Resonant of either an
employee/employer relationship or an independent contractor/client relationship,
whichever is relevant.”

8. **Paragraph 9**

8.1 In paragraph 9.3.9 of the Interpretation Note it is stated that an amount paid to a
VAT vendor that is considered to be ‘remuneration’ as defined in the Fourth
Schedule (therefore not payment to an independent contractor as defined), would
be subject to PAYE (excluding the VAT portion).

8.2 Subparagraph (c)(iii)(aa) and (bb) of the definition of “enterprise” in section 1 of
the VAT Act excludes from the definition of an “enterprise” for VAT purposes
the following:

“(aa) the rendering of services by an employee to his employer in the course
of his employment or the rendering of services by the holder of any
office in performing the duties of his office, shall not be deemed to be
the carrying on of an enterprise to the extent that any amount
constituting remuneration as contemplated in the definition of
“remuneration” in paragraph 1 of the Fourth Schedule to the Income
Tax Act is paid or is payable to such employee or office holder, as the case may be;

(bb) subparagraph (aa) of this paragraph shall not apply in relation to any employment or office accepted by any person in carrying on any enterprise carried on by him independently of the employer or concern by whom the amount of remuneration is paid or payable;”

8.3 It therefore appears that if an amount paid is remuneration as defined in the Fourth Schedule, it should not be subject to VAT (subparagraph (aa) above). If however it is paid to an independent contractor it should be subject to VAT (considered to be an enterprise – subparagraph (bb) above).

8.4 As a result of the above there appears to be uncertainty in practice when an amount paid to a VAT vendor (as per a VAT invoice raised because it is considered part of a trade carried on independently by the Vendor) would not be considered a payment to an independent contractor as per Interpretation Note 17, and therefore should be subject to PAYE? It is requested that the Interpretation Note provide further guidance in this regard, and explain the relationship between the Interpretation Note and the VAT definition of ‘enterprise’ in more detail.

9. **Annexure**

9.1 In our view, the flow diagram provided in respect of an (a) type of employee at Annexure A should firstly apply the common law test and thereafter the statutory test (see paragraph 2.3 of this document).

9.2 Annexure A also does not provide for the application of the proviso to exclusionary paragraph (ii) (i.e. consideration as to whether the person employs three or more employees on a full time basis - see paragraph 5.3 of this document).

9.3 Annexure A: Third column, paragraph (c) type employee: With regard to a labour broker (natural person):

- The flow diagram indicates that one needs to consider whether the labour broker is registered for employees' tax purposes. All labour brokers will not necessarily need to register for employees' tax purposes. In terms of paragraph 15 of the Fourth Schedule, where all the employees of an employer will earn below the threshold, there is no obligation to register.
- The flow diagram indicates that it should be considered whether 3 factors are present (i.e. 80% from one client, contractual obligation etc). It is submitted that this question should be changed to whether the labour broker is in possession of an IRP 30 exemption certificate as these factors needs to be applied by SARS when considering the IRP 30 application and not by the person determining the labour broker's status.
- The flow diagram indicates that the dominant impression test should be applied to labour brokers where applicable. It is submitted that this is not in line with the Interpretation Note. It is also not considered to be in line with legislation and this also raises the question whether one should apply the
provisions for individual contractors to labour brokers. SARS should elude whether this is their intention.

9.4 In the first paragraph of Annexure C the Interpretation Note states that the term “independent contractor” is a colloquial term for a small-time sub-contractor / entrepreneur. It is submitted that this statement is not correct and should be removed. Firstly, the term is given substance in common law and is not a colloquial term. In addition, not all independent contractors are small-time sub-contractors, since even large listed companies may be described as such.

9.5 The common law dominant impression indicators are discussed in an extensive and useful manner. This is to be commended.

10. **General**

10.1 The Interpretation Note is extremely comprehensive and appears to be well drafted.

Please do not hesitate to contact me should you wish to discuss the above.

Yours faithfully

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**PROJECT DIRECTOR: TAX**
*The South African Institute of Chartered Accountants*