GENERAL GUIDANCE NOTE
Taxation of non-executive directors' fees

Introduction

The purpose of this guidance note is to address the tax provisions applicable to non-executive directors ("NEDs") fees and clarify the interpretation thereof[1]. The need for this guidance note largely stems from a recent article[2] highlighting the need for NEDs to register for value-added tax ("VAT"), which has caused much debate on the taxation of non-executive directors' fees ("NED fees").

This guidance note contains:

As is the case with the Companies Act[3], the Income Tax Act[4] does not distinguish between executive and non-executive directors. There is however a distinction between the employee status of directors of public companies and private companies for employees' tax purposes, as discussed in Part A. The distinction between executive and non-executive directors is also relevant for VAT purposes, as discussed in Part B.

It is also important to note upfront that there are differing interpretations on some of the legal requirements, with clarity still needed from the South African Revenue Service ("SARS") (being the

[1] This guidance note does not deal with NEDs appointed to companies as representatives of corporate shareholders and who assumes the position as part of their employee/employer relationship with that corporate shareholder and where these corporate shareholder employees do not earn any non-executive director's fees in their personal capacity.

[2] http://www.moneyweb.co.za/mymoney/moneyweb-tax/non-exec-directors-could-face-substantial-vat-liability/.

[3] Companies Act No. 71 of 2008.

[4] Income Tax Act No. 58 of 1962.

enforcer) and National Treasury (being the policy setter). Until such time as SARS providing the clarity required, this guidance note is based on the letter of the law at the date of publication.

Whilst we are not specifically aware of pending changes to the various tax legislation affecting NEDs, we are aware that various role players, including the IoDSA, have approached SARS for guidance/clarity/amendments to the legislation. The IoDSA will continue to monitor this and engage with policy-makers.

Subsequent to the release of this guidance note, the following was contained in The Minister of Finance, Pravin Gordhan's 2016 budget speech to the National Assembly on 24 February 2016.

Taxation of non-executive directors' fees

Under the Income Tax Act and the Value-Added Tax Act, a non-executive director's fees may be subject to both PAYE/payroll tax and VAT. Views differ on whether to deduct PAYE from these fees or if the director should register as a VAT vendor. It is proposed that these issues be investigated to provide clarity.

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Executive Summary

There has been much confusion and debate around the issue of tax on NED fees. Some are of the view that NEDs should be subject to employees' tax, whilst others believe that they should not be subject to employees' tax and may need to register for VAT, if they earn R1 000 000 or more per 12 month period. The decision as to whether employees' tax is required to be withheld requires interpretation of the specific legislation by the company concerned and the company bears the risk of penalties and interest if employees' tax should have been withheld and none was. A probable unintended consequence of the way the legislation is drafted, is that some NEDs may be subject to both employees' tax and VAT, based on interpretation of the provisions of both the Income Tax Act and the Value-Added Tax Act[5] ("VAT Act") by both the NEDs and the companies on which boards they serve.

Based on the reasoning provided in Parts A and B of this guidance note, the following summarises the taxation position of NED fees.

Type of Director	#	Subject to employees tax deduction	Subject to VAT
Executive director	1	Yes	No
Non-resident NED	2	Yes	No
Resident NED	3	No, if considered independent contractor	Yes if over threshold of R1m in a 12 month period
	4	Yes, if considered an employee (unlikely)	Yes if over threshold of R1m in a 12 month period.

If one takes the stance as has been adopted in this guidance note, that NEDs are independent contractors (scenario 3 in the table above), technically a situation should not arise where the NED levies VAT on his NED fees and those NED fees are subject to employees' tax as well.

However, as there are differing views on whether NEDs are "employees" of the company and the NED fees earned are "remuneration", situations arise in practice where companies withhold employees' tax on the NED fees paid notwithstanding that the NEDs may consider themselves independent contractors, and hence carrying on an "enterprise". The NEDs may therefore be required to levy VAT on their NED fees should they be registered vendors for VAT purposes (scenario 4 in the table above)**.**

It should be noted that where this is the case, the employees' tax would be determined on the NED fees excluding VAT.

[5] Value-Added Tax Act No 89 of 1991.

An interesting practical consideration is whether NED fees are considered inclusive or exclusive of VAT. In the absence of any specific reference to VAT in the agreement entered into between the NED and the company, the NED fees are deemed to be inclusive of VAT. It is therefore important that the NED clearly state whether the fee is inclusive or exclusive of VAT.

From an independent NED's perspective, who is a registered VAT vendor, if one assumes that the fee is exclusive of VAT, he/she would be in the same net position if employees' tax is also deducted, as the employees tax would be calculated on the VAT exclusive amount. **Hence this would not have significant financial impact on the NED except for the admin time/cost/burden of being a VAT vendor. There is thus no double taxation as seems to be a concern in certain quarters.**

For example if a NED earns NED fees of R 2 000 000, he/she would invoice the company as follows:

NED fees	R 2 000 000
VAT	R 280 000
Total payable	R 2 280 000

Income tax would then be payable on the R 2 000 000, which would have been the same position had the NED not been regarded as carrying on an enterprise for VAT purposes.

If however a NED earns NED fees of R 2 000 000, and he/she is a VAT vendor but no reference is made to VAT in the agreement with the company, the NED fees would be regarded to be inclusive of VAT and the position will be as follows:

NED fees	R 1 754 386
VAT	R 245 614
Total payable	R 2 000 000

Income tax would then be payable on the R 1 754 386, i.e. the amount remaining after taking into account the VAT payable on the NED fees.

In conclusion, each individual NEDs taxation circumstance would be unique. As noted in the detail contained in this guidance note, there are a number of considerations that need to be taken into account in determining whether employees' tax and VAT are applicable. We would thus encourage members practising as NEDs to obtain individual advice from a tax specialist in respect of their specific situation.

PART A - Employee tax implications

The Income Tax Act requirements……

The deduction or withholding of employees' tax from **remuneration** paid or payable by an employer to an **employee** is required in terms of the Fourth Schedule to the Income Tax Act. The term "employee" is defined in paragraph 1[6] of the Fourth Schedule and includes "*any person. . . who receives any remuneration or to whom any remuneration accrues*" (paragraph (a) of the definition). Since executive directors are salaried employees their tax position is clear and they are subject to employees' tax.

The position with regards to NEDs is more complicated. Whether NEDs are subject to employees' tax depends on whether they are regarded as **employees** for tax purposes and whether they receive **remuneration**.

The term "employee" also specifically includes "*a director of a private company who is not otherwise included in paragraph (a)*" of the definition. No reference is made in the Income Tax Act to whether the director of the private company receives "remuneration" or not. Even though directors of public companies are not brought into the definition of employee, they will still be subject to employees' tax if they receive "remuneration".

[6] "employee" means (a) any person (other than a company) who receives any remuneration or to whom any remuneration accrues; (b) any person who receives any remuneration or to whom any remuneration accrues by reason of any services rendered by such person to or on behalf of a labour broker; (c) any labour broker; (d) any person or class or category of person whom the Minister of Finance by notice in the Gazette declares to be an employee for the purposes of this definition; (e) any personal service provider; (f)…;(g) any director of a private company who is not otherwise included in terms of paragraph (a).

Then to determine whether NEDs fees could be considered "remuneration"

What is "remuneration"?	
Residents	Non-residents
The definition of "remuneration" is wide and includes "any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, in cash or otherwise and whether or not in respect of services rendered" amongst others. Excluded from "remuneration" though is "*any amount paid or payable in respect of services rendered or to be rendered by any person* ***in the course of any trade carried on by him independently*** *of the person by whom such amount is paid or payable and of the person to whom such services have been or are to be rendered*" subject to certain provisos. **NED fees paid or payable to resident independent contractors are therefore excluded from "remuneration"** and are therefore not subject to employees' tax.	The exclusion applicable to resident independent contractors does not apply to non-residents. Employers are therefore obliged to withhold employees' tax from amounts which will be regarded to be "remuneration" notwithstanding that the non-resident may be an independent contractor. **NED fees payable to non-resident NEDs will therefore always be subject to employees' tax**. This will apply in the case of both private and public companies. The provisions of any double tax agreement between South Africa and the country of residence of the NED must be considered. It is however noted that in general, the right to tax NED fees are usually awarded to the country of residence of the company of which the non-resident is a director.

The status of resident NEDs will depend on whether they receive "remuneration" or qualify as independent contractors; since independent contractors do not receive "remuneration" for income tax purposes as set out in the table above.

So in principle, if the:		
NED is an independent contractor	→	No employees' tax should be withheld
NED is not an independent contractor	→	Employees' tax should be withheld

 One therefore needs to determine whether NEDs are independent contractors

What is an independent contractor?

The concept of an "independent contractor" still remains one of the more contentious features of the Fourth Schedule to the Income Tax Act. There are a number of statutory (i.e. conclusive) and common law tests which, if met, would classify a person as not being an independent contractor.

Summary of statutory and common law tests applicable to resident NEDs

For a person to be treated as an independent contractor, he/she needs to pass both the statutory and the common law (dominant impression) tests.

In terms of the statutory test, a person will not be considered to be an independent contractor if:

- the services are required to be performed mainly at the premises of the person by whom the amount concerned is paid or payable or of the person to whom such services were or are to be rendered; or
- they are subject to the control or supervision of any other person as to the manner in which their duties are performed or to their hours of work.

Where any of these tests apply positively, the individual is deemed not to be an independent contractor and the amount so received by him/her is therefore not excluded from remuneration; without consideration of the common law tests being necessary.

Notwithstanding the above, an independent contractor who employs three or more full-time employees, who are not connected persons in relation to him or her and are engaged in his or her business throughout the particular year of assessment, will be deemed to be carrying on a trade independently.

If the statutory tests discussed above are not positive, consideration then needs to be given to the common law dominant impression test, which overlaps with the statutory tests in some respects. These tests essentially seek to determine whether the control over a person's productive capacity has been surrendered. Near conclusive consideration to be taken into account for the common law test include:

- Whether the company has control over the manner of work?
- Whether payment is made with reference to a result or to effort?
- Whether substitution is allowed in person rendering the service?
- Whether obligation to work is linked to time or results?
- Whether the company has exclusive use over the individual's time? and
- Whether the individual is exposed to risk (shares in profits and losses)?

In addition to the above there are a number of persuasive and resonant indicators that can be considered.

Reference should be made to the detail contained in SARS Interpretation Note 17[7] to determine this for each individual circumstance.

Application of independent contractor tests to NEDs

There is currently little consensus amongst tax practitioners, including the accounting firms, on whether NEDs are independent contractors or not for employees' tax purposes. This is problematic as an NED may be on the boards of many companies and be regarded as an independent contractor by some of the companies and not by others. Consequently, employees' tax may be withheld by those companies that regard the NEDs to be employees whereas no employees' tax is withheld by those companies which regard the NEDs to be independent contractors. The situation is further exacerbated by the fact that neither the companies nor the NEDs can approach SARS for a binding ruling regarding this issue as applications to determine whether an individual is an independent contractor are specifically listed as applications which will be rejected by SARS.

NEDs do not have contracts which regulate their hours of work and are not under the supervision and control of the company as to the manner in which they fulfil their duties. Although typically the NED fees they receive are based on a retainer and the number of board meetings attended, these meetings are sometimes held only quarterly or less often. Since the NEDs fiduciary duties and obligations typically extend far beyond the mere attendance of board meetings, such as to prepare for meetings, remain abreast of company developments, understand the business of the company and keep up to date with legal and governance developments, the majority of their duties are performed away from the company's premises.

The role of NEDs requires them to maintain an independent and autonomous stance in relation to the company in order to provide oversight, challenge policy and strategic decisions. It could thus be argued that the very nature of NEDs fiduciary duties makes them independent in relation to the company and that they do not place their productive capacity at the disposal of the company and should not be involved in the day to day running of the operations of the company. Accordingly, it is our view that NEDs are independent contractors, in terms of both the statutory and common law tests, and as a result NED fees paid to NEDs do not constitute "remuneration" for employees' tax purposes

[7] http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-17-Arc-19%20-%20IN17%20Issue%202%20Archived%20on%2031%20March%202010.pdf

Responsibility of the company

Every company must determine the employees' tax payable on "remuneration" based on the tax deduction tables provided by SARS. Refer to Annexure 2 for guidance on determining tax thresholds for NED fees. The employer must comply with the provisions of the Fourth Schedule of the Income Tax Act in respect of deduction, payment and reporting of the employees' tax withheld, failing which could result in penalties and interest payable by the employer. Annexure 3 contains some guidance around possible penalties applicable to both the company and the NED.

If it is determined that employees' tax should be deducted from a NEDs fees (which in our view is unlikely), such income should be classified as code 3616 for payroll purposes. If such income is classified under 3601 (which is for normal salary and similar payments), the NED should contact the company to change this, as this error may prevent you from claiming certain business expenses.

If the NED is considered to be an independent contractor (as is our view), there would be no payroll code and this payment would not be processed through the payroll.

What if the NED fees are paid to/billed from another entity?

Section 69(7) of the Companies Act disqualifies a juristic person, for example companies and trusts, form being appointed as directors of any company. Therefore, directors, including NEDs, of companies can only be natural persons. Whilst the NED may direct that the company pays the NED fees to another entity, for example a company or a trust, the appointment is made in the NED's personal capacity.

Paragraph (*c*)(ii) of the definition of "gross income" contained in section1 of the Income Tax Act further provides that "*any amount received by or accrued to or for the benefit of any person in respect of services rendered or to be rendered by any other person shall … be deemed to have been received by or to have accrued to the said other person*". This means that, notwithstanding that the NED fees may be paid to another entity, the NED fees will accrue to the NED in his/her personal capacity and the NED will be liable for income tax on the NED fees in his/her personal capacity. The tax consequences will therefore be the same as noted above.

Conclusion – income tax

NED fees paid to non-resident NEDs are subject to employees' tax. Resident NEDs of public or private companies are most likely independent contractors and any NED fees payable to them will most likely not be subject to withholding employees' tax as per the arguments above on the statutory and common law tests. Also refer to the flow diagram attached as Annexure 1.

The company must however ensure that the NEDs are indeed independent contractors to avoid any penalties and interest should it be found that the NEDs are not independent contractors.

Should the deduction of employees tax not be a legal requirement (i.e. the NED is considered an independent contractor), the NED could still request for employees' tax to be withheld by the company on which board he/she serves. It should be noted however that this would not in any way remove the need for the NED to register for VAT as discussed below.

As a separate consideration to the above employees' tax discussion, NEDs would also need to determine whether they should register as provisional taxpayers. See Annexure 4 for further detail.

PART B - Value-added tax implications

The VAT Act provides that the services rendered 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, to the extent that the employee or office holder is receiving **"remuneration", are not subject to VAT**, as such services are not included in the definition of an "enterprise" contained in section 1 of the VAT Act.[8]

"Remuneration" in this context takes the meaning as defined in paragraph 1 of the Fourth Schedule of the Income Tax Act, and includes all amounts from which employees' tax is deducted for income tax purposes, as well as remuneration paid to directors of companies where those directors are not considered "independent contractors". **In regards to both employees and office holders such as directors, however, it is only "remuneration" as defined that falls outside the scope of VAT.**

This exclusion does not apply in the case of services rendered by a person in the course of **any enterprise carried on by him independently of the employer or concern** remunerating him. Independent contractors do not receive "remuneration" and will therefore carry on an "enterprise" for VAT purposes.

A person is considered to be carrying on an "enterprise" if all of the following requirements are met:

- An enterprise or activity is carried on **continuously or regularly** by a person in the Republic or partly in the Republic;
- Goods or **services are supplied** to another person in the course or furtherance of the enterprise or activity; and
- **Consideration is payable** for the goods or services supplied.

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[8] The relevant provisions of the definition of **"enterprise"** are –

(*a*) in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club;

…

Provided that –

…

(iii)(*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:

There is a view that holding one NED position would not constitute a "continuously or regularly" activity. Our view is that even with only one board position, the appointment as NED of a company will require steadiness or uniformity of action, or occurrence of action, which recurs or is repeated at fairly fixed times, or at generally uniform intervals. Refer to Annexure 5 for further discussion on this.

Under our common law a director, including an NED, of a company stands in a fiduciary position in relation to the company of which he is a director. This status requires him to exercise his powers with independence of mind and in the interests of the company. It may therefore be argued that a NED renders his services independently of the company, and accordingly that the services of an NED are *prima facie* included in the definition of an "enterprise".

It furthermore seems that the services of an NED generally fulfils all three of the above conditions. If this is indeed the case an NED must register for VAT if his/her NED fees (including any other non-NED fees) **exceed the registration threshold** (currently R 1 000 000 for a 12 month period).

The VAT Act provides that any price charged by a vendor[9] in respect of a taxable supply of goods or services are deemed to include any VAT payable. NEDs should therefore ensure that their agreed NED fees are stated as either inclusive or exclusive of VAT.

The mechanics of the VAT system are based on a subtractive or credit input method which allows the vendor to deduct the tax incurred on enterprise inputs (input tax) from the tax collected on the supplies made by the vendor (output tax). There are, however, some expenses in respect of which input tax is specifically denied, such as the acquisition of motor cars and entertainment. NEDs will therefore have to account for the VAT levied on their NED fees as output tax and they will be able to claim input tax on any VAT paid on supplies made to them to the extent that those supplies relate to their NED services and are not expenses in respect of which the input tax is specifically denied.

The company will in turn be able to claim an input tax credit for the VAT paid to the NED provided the company is registered and the services rendered by the NED are in respect of the enterprise carried on by the company.

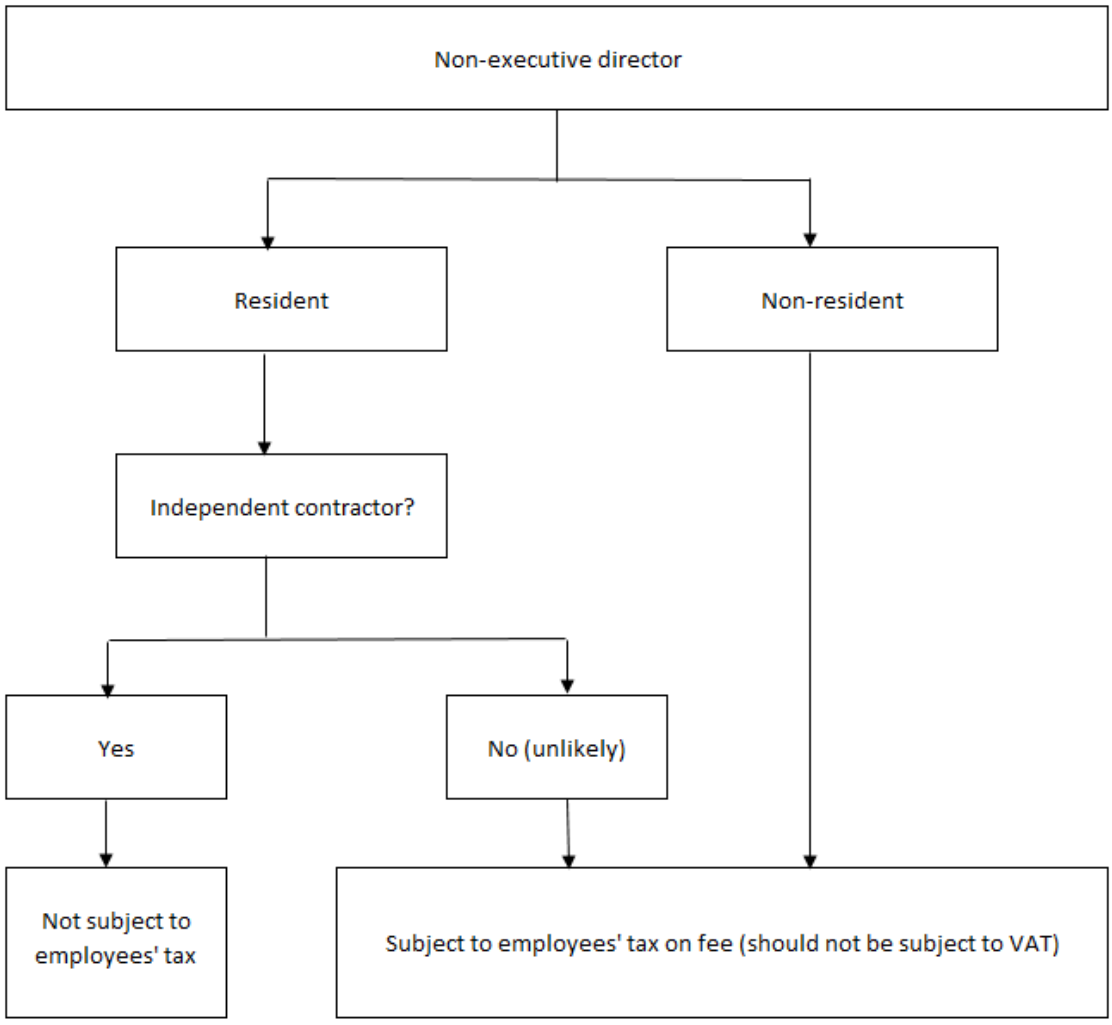
As is the case with income tax, penalties and interest are payable for non-compliance with the provisions of the VAT Act.

Conclusion – value-added tax

VAT is levied on an enterprise as defined, which initially excludes employees, but negates this exclusion for individuals carrying on an enterprise independently. From a NEDs perspective this means that they would most likely be caught in the VAT net if their NED fees exceed R 1 000 000 for a 12 month period.

[9] A "vendor" includes a person carrying on an enterprise that should be registered for VAT purposes but is not registered, i.e. it includes any person who are liable for VAT.

Annexure 1 – Employees' tax flow diagram



Annexure 2 - Tax thresholds (applicable to NEDs required to pay income tax)

Based on the opinion that resident NEDs are independent contractors, any NED fees paid to them in that role should not be subject to employees' tax. Non-resident NEDs are however subject to employees' tax and the following information is therefore relevant to "remuneration" paid to the non-resident NEDs and will also be relevant to any "remuneration" paid to resident NEDs (where this interpretation is taken).

The provisions of paragraph 11C of the Fourth Schedule to the Income Tax Act should be taken into account if the NEDs receive "remuneration" as defined. Paragraph 11C requires that the *quantum* of the employees' tax be determined, by means of a formula, on a notional or deemed amount, referred to as the "deemed remuneration". The concept "deemed remuneration" is a purely notional amount, determined with reference to the remuneration paid in the last year of assessment. The director is deemed to have received a minimum amount of remuneration every month, and the company must on a monthly basis withhold as employees' tax an amount equal to one-twelfth of the director's remuneration for the previous year.

The notion of "deemed remuneration" will not apply in respect of a director who, in the preceding year of assessment, derived more than 75% of his balance of remuneration in the form of fixed monthly payments of remuneration. Instead he/she will be subject to the withholding of employees' tax from his/her actual remuneration. In other words, paragraph 11C will not apply.

The rate of tax will depend on the value of the NED fee and must be determined with reference to the employees' tax tables issued by South African Revenue Service ("SARS").

Annexure 3 - Penalties for non-compliance

In the case of NEDs of public companies, it is important to note that the responsibility rests on the companies paying the NEDs to decide whether the NEDs are independent contractors or not. If SARS concludes that the decision is not correct, the company concerned will be liable to pay the employees' tax and recover the resultant overpayment of remuneration from the NEDs. SARS may also recover the unpaid employees' tax from the NEDs.

The penalties and interest in the case of non-compliance are severe should a company fail to pay over the amount of employees' tax for which it is liable within the period allowed.

NEDs who fail to register for provisional tax and fail to submit provisional tax returns may also be subject to under-estimation penalties on the under-estimation of their provisional tax of 20%[10] as well as non-compliance penalties levied in terms of section 223 of the Tax Administration Act[11]. The non-compliance penalties are levied based on a penalty percentage table as follows:

1	2	3	4	5	6
Item	*Behaviour*	*Standard case*	*If obstructive, or if it is a 'repeat case'*	*Voluntary disclosure after notification of audit or investigation*	*Voluntary disclosure before notification of audit or investigation*
(i)	"Substantial understatement"	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing return	25%	50%	15%	0%
(iii)	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
(iv)	Gross negligence	100%	125%	50%	5%
(v)	Intentional tax evasion	150%	200%	75%	10%

[10] Levied in terms of paragraph 20 of the Fourth Schedule to the Income Tax Act

[11] Tax Administration Act, 2011 (Act No 28 of 2011)

Annexure 4 - Provisional tax responsibility of the NED

One of the legal responsibilities of NEDs with regards to tax is to register for provisional tax in circumstances as explained in the table below.

If NEDs are considered employees for income tax purposes	*If NEDs are considered independent contractors*
Unless SARS otherwise directs, directors and NEDs are not required to register for provisional tax purposes.	Unless SARS otherwise directs, NEDs of both public and private companies who are regarded as independent contractors are provisional taxpayers if they earn income from the carrying on a business, i.e. the provision of NED services, which is not remuneration.

Annexure 5 – Continuity or regularity of the enterprise

One requirement of an "enterprise" is continuity or regularity of the enterprise or activity. The terms are not defined although "continuously" is generally interpreted as unchanged or uninterrupted, that is, the duration of the activity is continuing without changing, stopping, or being interrupted in space or time; nor has it ceased in a permanent sense. The term "regularly" refers to an activity that occurs in a fixed, unvarying, or predictable pattern, with equal amounts of time or space between each one. Therefore, an activity can be regular if it is carried out on a regular basis according to an established routine or schedule repeated at reasonably fixed intervals taking into consideration the type of supply and the time taken to complete the activities associated with making the supply.

As a general rule, isolated or "once-off" transactions will not qualify as conducting "an enterprise". But it may not always be easy to determine, particularly when a series of steps is involved, whether a transaction may correctly be classified as an isolated event, as opposed to an activity carried on continuously or regularly.

There is no South African VAT authority on the interpretation of the terms. The New Zealand Taxation Review Authority has interpreted the word "continuously" to mean that the "*activity has not ceased in a permanent sense or has not been interrupted in a significant way. . . The object and purpose or the physical break in the activity, whether it be for rest, recreation, health and such like reasons may be of importance in determining whether the activity is being carried on continuously*."

In regard to the word "regularly", Bathgate DJ in Case N27 (1991) 13 NZTC 3,299 at 3,239 held that it involved "*a steadiness or uniformity of action, or occurrence of action, so that it recurs or is repeated at fairly fixed times, or at generally uniform intervals, to be of a habitual nature and character*." In *Allen Yacht Charters Limited v CIR (*(1994) (16 NZTC 11,270) it was held by the New Zealand High Court that the words "continuously or regularly" indicate that "*the activity must either be carried on all the time, that is, continuously, or it must be carried on at reasonably short intervals, that is, regularly. An activity that is intermittent or occasional does not qualify*."