

**INTERPRETATION NOTE: NO. 35 (ISSUE 3)**

DATE: 31 March 2010

**ACT : INCOME TAX ACT, NO. 58 OF 1962 (the Act)**  
**SECTION : PARAGRAPHS 1, 2(1A) AND 2(5) OF THE FOURTH SCHEDULE AND SECTION 23(k)**  
**SUBJECT : EMPLOYEES' TAX: PERSONAL SERVICE PROVIDERS AND LABOUR BROKERS**

***Preamble***

Legislative references in this Note to sections are to sections of the Act and references to paragraphs are to paragraphs of the Fourth Schedule to the Act, unless the context indicates otherwise.

**1. Purpose**

This Note incorporates the latest amendments made by section 66(1) of the Revenue Laws Amendment Act, No. 60 of 2008, which introduces a definition of a “personal service provider”, and limits the definition of a “labour broker” to natural persons.

**2. Background**

The use of labels such as “independent contractor” and “service company” and the perception that they are acceptable means of avoiding the deduction of employees’ tax and compliance with labour legislation, necessitated the development of stronger anti-avoidance measures for employees’ tax purposes.

Interpretation Note No. 17 (Issue 3) “Employees’ Tax: Independent Contractors” focuses on some of the more pertinent issues relating to independent contractors. This Note focuses on the so-called interposed entities. Recent amendments introduced the concept of “personal service provider” to replace the definitions of “personal service company” and “personal service trust”. Substantive amendments were also introduced to reduce the administrative burden on labour brokers.

**3. The law**

**Paragraph 1 – Definitions**

**“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; and
- (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; and
- (e) any personal service provider; and
- (f) .....
- (g) any director of a private company who is not otherwise included in terms of paragraph (a);

**“labour broker”** means any natural person who conducts or carries on any business whereby such person for reward provides a client of such business with other persons to render a service or perform work for such client, or procures such other persons for the client, for which services or work such other persons are remunerated by such person;

**“personal service provider”** means any company or trust, where any service rendered on behalf of such company or trust to a client of such company or trust is rendered personally by any person who is a connected person in relation to such company or trust, and—

- (a) such person would be regarded as an employee of such client if such service was rendered by such person directly to such client, other than on behalf of such company or trust; or
- (b) where those duties must be performed mainly at the premises of the client, such person or such company or trust is subjected to the control or supervision of such client as to the manner in which the duties are performed or are to be performed in rendering such service; or
- (c) where more than 80 per cent of the income of such company or trust during the year of assessment, from services rendered, consists of or is likely to consist of amounts received directly or indirectly from any one client of such company or trust, or any associated institution as defined in the Seventh Schedule to this Act , in relation to such client,

expect where such company or trust throughout the year of assessment, employs three or more full-time employees who are on a full-time basis engaged in the business of such company or trust of rendering any such service, other than any employee who is a shareholder or member of the company or trust or is a connected person in relation to such person;

### **Paragraph 2(1A) – Affidavit in respect of 80% rule**

(1A) Notwithstanding the provisions of subparagraph (1), a person shall not be required to deduct or withhold employees' tax solely by virtue of paragraph (c) of the definition of " personal service provider" where the company or trust has provided that person with an affidavit or solemn declaration stating that the relevant paragraphs do not apply and that person relied on that affidavit or declaration in good faith.

### Paragraph 2(5) – Certificate of exemption in respect of a labour broker

(5)(a) The Commissioner shall on application made to him by any person who is a labour broker or who is an employee by reason of the provisions of paragraph (d) of the definition of "employee" in paragraph 1, issue to such person a certificate of exemption if—

- (i) such person carries on an independent trade and is registered as a provisional taxpayer under the provisions of paragraph 17;
- (ii) in the case of any such labour broker, he is registered as an employer under the provisions of paragraph 15; and
- (iii) such person has, subject to any extension granted by the Commissioner, submitted all such returns as are required to be submitted by him under this Act:

Provided that the Commissioner shall not issue a certificate of exemption if—

(aa) more than 80 per cent of the gross income of such person during the year of assessment consists of, or is likely to consist of, an amount or amounts received from any one client of such person, or any associated institution as defined in the Seventh Schedule to this Act in relation to such client unless that person is a labour broker who throughout the year of assessment employs three or more full-time employees—

(A) who are on a full-time basis engaged in the business of that labour broker of providing persons to or procuring persons for clients of that labour broker; and

(B) who are not connected persons in relation to that labour broker;

(bb) such labour broker provides to any of its clients the services of any other labour broker; or

(cc) such labour broker is contractually obliged to provide a specified employee of such labour broker to render any service to such client.

(b) The certificate of exemption referred to in item (a) shall be issued in such form as the Commissioner may decide and shall be valid for such period as the Commissioner may indicate thereon.

(c) An employer shall not be required to deduct or withhold employees' tax from any remuneration paid or payable by him to any person who produces to the employer a valid certificate of exemption issued by the Commissioner under item (a).

### Section 23(k) – Limitation of allowable deductions

**23. Deductions not allowed in determination of taxable income.**—No deductions shall in any case be made in respect of the following matters, namely—

(k) any expense incurred by—

(i) a labour broker as defined in the Fourth Schedule, other than a labour broker in respect of which a certificate of exemption has been issued in terms of paragraph 2(5) of the said Schedule; or

(ii) a personal service provider as defined in the said Schedule;

other than any expense which constitutes an amount paid or payable to any employee of such labour broker, or personal service provider for services rendered by such employee, which is or will be taken into account in the determination of the taxable income of such employee and, in the case of such personal service provider any expense, deduction or contribution contemplated in paragraph (c), (i) (l), (nA) or (nB) of section 11, expenses in respect of premises, finance charges, insurance, repairs and fuel and maintenance in respect of assets, if such premises or assets are used wholly and exclusively for purposes of trade;”

#### 4. Interpretation of the law

By way of background, and as explained in Interpretation Note No. 17, the deduction of employees' tax is dependent on three elements, namely, an employer, an employee and the payment of remuneration. All three elements are defined in the Fourth Schedule. Employees' tax cannot be charged where one or more of these three elements are not present. If, for example, an "employee" is removed from the equation, the person paying the remuneration has no responsibility to deduct employees' tax. Similarly, if the term "remuneration" is removed from the equation, no employees' tax liability arises. If remuneration is therefore paid to somebody who is not an "employee" as defined in the Fourth Schedule, or if something other than "remuneration" is paid to somebody, no employees' tax needs to be deducted.

Previously it was a popular tax-saving method for employees to offer their services to their employers through the medium of private companies, close corporations or trusts. In order to discourage the use of corporate entities or trusts as intermediaries to provide personal services to a client which are, in essence, services provided in terms of a contract of employment, legislation was introduced that required remuneration payable to such a company, close corporation or trust by the client be subject to employees' tax and which limited the available deductions from income in the determination of taxable income for these entities.

##### 4.1 Personal service provider

Any company, close corporation or trust that fits the definition of a "personal service provider" **and** which is in receipt of "remuneration" as defined in the Fourth Schedule is subject to the deduction of employees' tax.

In determining whether a company, close corporation or trust is a "personal service provider" and whether or not employees' tax is recoverable from payments made to them the following tests should be performed:

- a) **Determine whether or not some or all of the receipts of the company, close corporation or trust consist of "remuneration" as defined in the Fourth Schedule.** If the receipts do not include "remuneration" as defined, no employee's tax is deductible. The definition of the term "remuneration" excludes payments made to independent contractors that are natural persons or trusts. The exclusion does not apply to personal service providers. There is no need, as a result, to determine whether the personal service provider is an "independent contractor" for purposes of the Fourth Schedule. If remuneration is paid or payable, proceed to the next test.

- b) **Determine whether the service is rendered personally by any person who is a connected person in relation to the company, close corporation or trust.** The term “connected person” is defined in section 1 and must be applied accordingly. “Service” includes the provisions of a person to render a service or work for a client (including, for example, companies, close corporations and trusts operating as labour brokers). If the service is rendered personally by any person who is a connected person in relation to the company, close corporation or trust, proceed to the next test below. If it is not the case, the company, close corporation or trust is not a “personal service provider” and it is not subject to the deduction of employees’ tax.
- c) **Determine whether the company, close corporation or trust employed (or is likely to employ) three or more full-time employees throughout the particular year of assessment who are on a full-time basis engaged in rendering the service, and who are not shareholders or members of the company or close corporation, or connected persons in relation to the person who is personally rendering the service or the trust.** If this is not the case, proceed to the next test below. If this is the case the company, close corporation or trust is not a “personal service provider” and therefore not subject to the deduction of employees’ tax.

**Example 1 – Classification of a personal service provider**

*Facts:*

X is the only member of ABC Close Corporation (the CC). She provides information technology consulting services. The CC employs two other consultants and an administrative assistant, all of whom are employed on a full-time basis for the full year of assessment and none of whom are connected persons in relation to X.

*Result:*

Because the CC employs three full-time employees for the full year of assessment, who are not members of the CC or are not connected persons in relation to X, the CC will not be classified as a personal service provider.

**AND**

d) **Determine whether one (or more) of the following is true:**

- **Would the person who is personally rendering the service have been regarded as an “employee” of the client if the service was rendered directly to the client and not through the company, close corporation or trust?** For purposes of employees’ tax, the word “employee” is defined in the Fourth Schedule and it is therefore necessary to determine whether the person would have been an “employee” as defined. For example, if the person would have been a person in receipt of remuneration or to whom remuneration accrues as described in paragraph (a) of the definition of an “employee”, the company, close corporation or trust is a “personal service provider”. Following the example through, the test must also include a reference to the definition of the term “remuneration” (because of its reference in paragraph (a) of the definition of an “employee”), which excludes payments made to common law independent contractors. If the person rendering the service would have been regarded as an independent contractor under common law (refer to Interpretation Note No. 17), the person would not have been regarded as an “employee” in the absence of the company, close corporation or trust.
- **Must the person who is personally rendering the service, or the company, close corporation or trust, perform the duties mainly at the premises of the client, and if so, is that person subject to the control or supervision of the client as to the manner in which the duties are performed or are to be performed?** The test is the same as the one used in exclusionary paragraph (ii) of the definition of the term “remuneration”. If the services are rendered mainly at the premises of the client and the client supervises or controls the activities of the person rendering the service or the activities of the company, close corporation or trust, the test is positive.
- **Does more than 80% of the income of the company, close corporation or trust from services rendered consist of or is likely to consist of amounts received from any one client, or from any associated institution in relation to the client?** If more than 80% of the income of the company, close corporation or trust consists (or is likely to consist) of income from only one client, the test is positive. The reference to “income” in the test is a reference to “income” as defined in section 1. It is necessary to isolate the income received for the services rendered from the income received for other activities of the company, close corporation or trust.

**Example 2 – Determination of income (more than 80%) derived from services rendered**

Company A is in receipt of R100 000 for the year of assessment, of which R90 000 is “income” as defined in section 1. R50 000 of the R90 000 represents income for services rendered. Of the R50 000, R42 000 (that is, more than 80% of R50 000) was earned from services rendered to one client and the test is therefore positive in respect of the company.

In instances where the first two tests in **4.1(d)** (above) do not apply and a company, close corporation or trust provides a client with an affidavit or solemn declaration stating that it will not derive more than 80% of its income from one client, the client may rely on the affidavit or solemn declaration, provided the client relies on it in good faith. If it later emerges that the company, close corporation or trust is, in fact, a personal service provider, employees' tax will not be recoverable from the client. However, the other provisions relating to a personal service provider [such as paying tax on taxable income at the rate of 33%, and the prohibition of deductions under section 23(k)] will apply as far as that personal service provider is concerned.

Section 23(k) limits the deduction of expenses which can be claimed by a personal service provider to the following:

- Remuneration paid to the employees of that personal service provider.
- Legal expenses.
- Bad debts.
- Contributions to pension fund, provident fund or benefit fund for the benefit of employees.
- So much of any amount, including any voluntary award received or accrued for services rendered or to be rendered or any amount received or accrued for or by virtue of any employment or the holding of any office as was included in the taxable income of that person and is refunded by that person.
- So much of any amount contemplated in paragraph (cA) of the definition of the term "gross income" (that is, restraint of trade payments) received by or accrued to any person as refunded by that person.
- Expenses for premises, finance charges, insurance, repairs and fuel and maintenance cost for assets where the premises or assets are used wholly or exclusively for the purposes of trade.

As the personal service provider may claim any expense, deduction or contribution listed above, it is apparent that a flat rate of tax applicable to personal service provider may far exceed the actual net liability eventually owed. Therefore, to reduce the cash-flow constraints, a personal service provider may apply at a SARS branch office for a tax directive under paragraph 11 for a lower rate of tax that more closely matches the final tax liability.

## **4.2 Labour broker**

As of 1 March 2009, a labour broker is any **natural person** who conducts or carries on any business whereby such person, for reward, provides a client with his or her own employees to perform work for the client or procures workers for a client but does not him or herself provide the services required by the client. A company, close corporation or trust that provides such services may no longer be classified as a labour broker.

A labour broker without an exemption certificate is subject to employees' tax at the rate applicable to individuals.

As of 7 February 2007, an exemption certificate may not be granted where –

- a) more than 80% of the gross income of the labour broker during the year of assessment consists of, or is likely to consist of, amounts received from any one client of the labour broker or from an associated institution of the client, **unless** the labour broker employs three or more full-time employees who are on a full-time basis engaged in the business of that labour broker and who are not connected persons in relation to the labour broker. It is important to note that the rule relating to the three or more employees does not apply to persons engaged in other activities of the labour broker – they must be directly involved in the labour broking activities of the labour broker; or
- b) the labour broker provides to any of its clients the services of another labour broker. This requirement does, however, not preclude a labour broker from acquiring an employee from another labour broker for purposes of providing the employee to a client. Where, for example, Labour Broker A is requested by a client to provide a particular type of employee that it does not possess, and Labour Broker A acquires this employee from Labour Broker B to become an employee of Labour Broker A and forwards the employee to the client in the normal way, Labour Broker A would not be penalised by this requirement because the employee is provided to the client as an employee of Labour Broker A. This requirement is applicable where, for example, a client is permitted to hire an employee of Labour Broker B through Labour Broker A; or
- c) the labour broker is contractually obliged to provide the services of a specified employee to the client. This requirement is applicable where, for example, the client prescribed or required Employee A to render the service. This requirement is not applicable in circumstances where an employee of the labour broker was chosen by name as a result of a *bona fide* selection process based on the requirements of the client, and specified as such in the eventual contractual agreement.

### **Example 3 – Determination of a labour broker**

*Facts:*

The client requires an information technology auditor. Labour Broker A conducts a selection process to determine the most suitable employee to render services to the client. Ms. B is selected by Labour Broker A and in the contract between the client and Labour Broker A, it is specified that Ms. B will render services to the client.

*Result:*

In this case the selection process was not influenced by the client and the exclusion is therefore not applicable.

It is important to note that the requirements for granting an exemption certificate still include the requirements that were operative before the introduction of the new requirements. From a practical point of view, however, it is easier to test the labour broker against the new requirements before attempting to classify the labour broker as either dependent or independent.



With the exception of amounts paid to employees for services rendered, section 23(k) prohibits the deduction of all expenses incurred by a labour broker for which a certificate of exemption has not been issued.

#### **4.3 Decision chart**

The legislation relating to the definition of an “employee” in the Fourth Schedule is illustrated by the chart in **Annexure A**. The process flow to determine whether an entity is a personal service provider is illustrated by the chart in **Annexure B**.

#### **5. The effect of the law**

A “personal service provider” as defined in the Fourth Schedule is an “employee” for purposes of employees’ tax. Therefore, employees’ tax must be deducted from remuneration paid or payable to a personal service provider.

A labour broker would not be granted an exemption certificate where any one of the prohibitions mentioned in **4.2** applies.

Section 23(k) affects a personal service provider and a labour broker without an exemption certificate. Under this section, any expenses incurred by a personal service provider or labour broker without an exemption certificate, other than expenses mentioned in **4.1** for the personal service provider or amounts paid or payable to employees as remuneration for a labour broker, are not permitted as a deduction for purposes of calculating taxable income. The Act does not provide for the apportionment of deductions where a personal service provider or labour broker is in receipt of more than one type of income. The provisions of section 23(k) will apply if a company, close corporation or trust falls within the above definition.

A personal service provider will, furthermore, not qualify as a “small business corporation” (as defined in section 12E) for purposes of the lower tax rates applicable to small business corporations. Both a personal service provider and a labour broker without a certificate of exemption (IRP 30) do not qualify as a micro business for the purposes of the turnover tax (Sixth Schedule to the Act).

A personal service provider will be subject to tax at the rate of 33%, as opposed to the normal corporate tax rate (currently 28%). A trust, if it is a “personal service provider” as defined in the Fourth Schedule, will remain taxable at normal trust rates (currently 40%) and not the rates applicable to special trusts.

It may become apparent, during the year of assessment, that a personal service provider or a labour broker will earn more than 80% of its income from one source. To avoid this unforeseen circumstance, employers must ensure at the outset that this situation is anticipated and that the applicable employees’ tax is deducted.

The client is not required to deduct employees’ tax if the company, close corporation or trust provided the client with an affidavit or solemn declaration stating that not more than 80% of the income of that company, close corporation or trust will be derived from one client. However, this exemption only applies if the client relied on the affidavit or solemn declaration in good faith and the other two requirements in **4.1(d)** do not apply.

## 6. The effective dates of implementation of the law

The definition of a “personal service provider” in the Fourth Schedule came into operation on 1 March 2009 and applies to the year of assessment commencing on or after that date.

The amendment to the definition of an “employee” replacing the definitions of a “personal service company” and a “personal service trust” by a definition of a “personal service provider” came into operation on 1 March 2009 and applies to a year of assessment commencing on or after that date.

The amendments to section 23(k) adding the new deductions that can be claimed by a “personal service provider” came into operation on 1 March 2009 and apply to a year of assessment commencing on or after that date.

The 80% requirement set out in paragraph (c) of the definition of a “personal service provider” may, with effect from 1 March 2009, be satisfied by means of an affidavit. This has the effect that, where an employer *bona fide* relies on such an affidavit, that employer is no longer required to satisfy itself as to whether that test has been met.

With regards to the definition of a “labour broker”, the effective date of the amendment is any year of assessment commencing on or after 1 March 2009. Therefore, a company or trust that previously satisfied the requirements to be a labour broker, and which has a financial year-end before 1 March 2009, for example 31 December 2008, will still be classified as a labour broker for the year of assessment ending 31 December 2009. Employees’ tax is deductible from payments made to a labour broker that is not in possession of a certificate of exemption.

## 7. Common misconceptions about the law

One of the areas that is typically misinterpreted is the relationship between the definition of an “employment company” in section 12E(4)(b) and the definition of a “personal service” in the section 12E(4)(d) on the one hand, and the definition of a “personal service provider” in the Fourth Schedule on the other. In this regard, it is important to note that the definitions of “employment company” and “personal service” were not created for purposes of determining whether or not a company or trust is a “personal service provider”. For example, a company is not a “personal service provider” because it provides a “personal service”, but because it complies with the definition of a “personal service provider” in the Fourth Schedule.

The term “personal service provider” is only applicable to a “company” and “trust” as defined in section 1. This means that the term is not applicable to a natural person. The effect of the new legislation can therefore be eliminated by rendering the service through a natural person directly to the client. By rendering the services directly as a natural person, the normal rules relating to the status of an independent contractor or common law employee as explained in previous guidelines issued by SARS become relevant.

Not all companies are affected by the legislation relating to personal service providers. Only companies that fall within the definition of a “personal service provider” are affected by the definition, and also only when those that fall within the definition are in receipt of “remuneration”, as defined.

It is recommended that all users of services (employer/client) from potential labour brokers and personal service providers should have policies and systems in place to correctly identify and withhold tax from these entities and individuals. A possible solution would be a questionnaire or an affidavit (including an affidavit or solemn declaration for a personal service provider indicating that not more than 80% of its income is derived or is likely to be derived from one client) that could be used by the service-user at the start of the engagement or contract and regularly thereafter. This will enable the client to determine whether employees' tax should be deducted or not.

#### **8. Applicable tax rates**

A labour broker without an exemption certificate is subject to employees' tax at the rates applicable to an individual.

In the case where the "personal service provider" is –

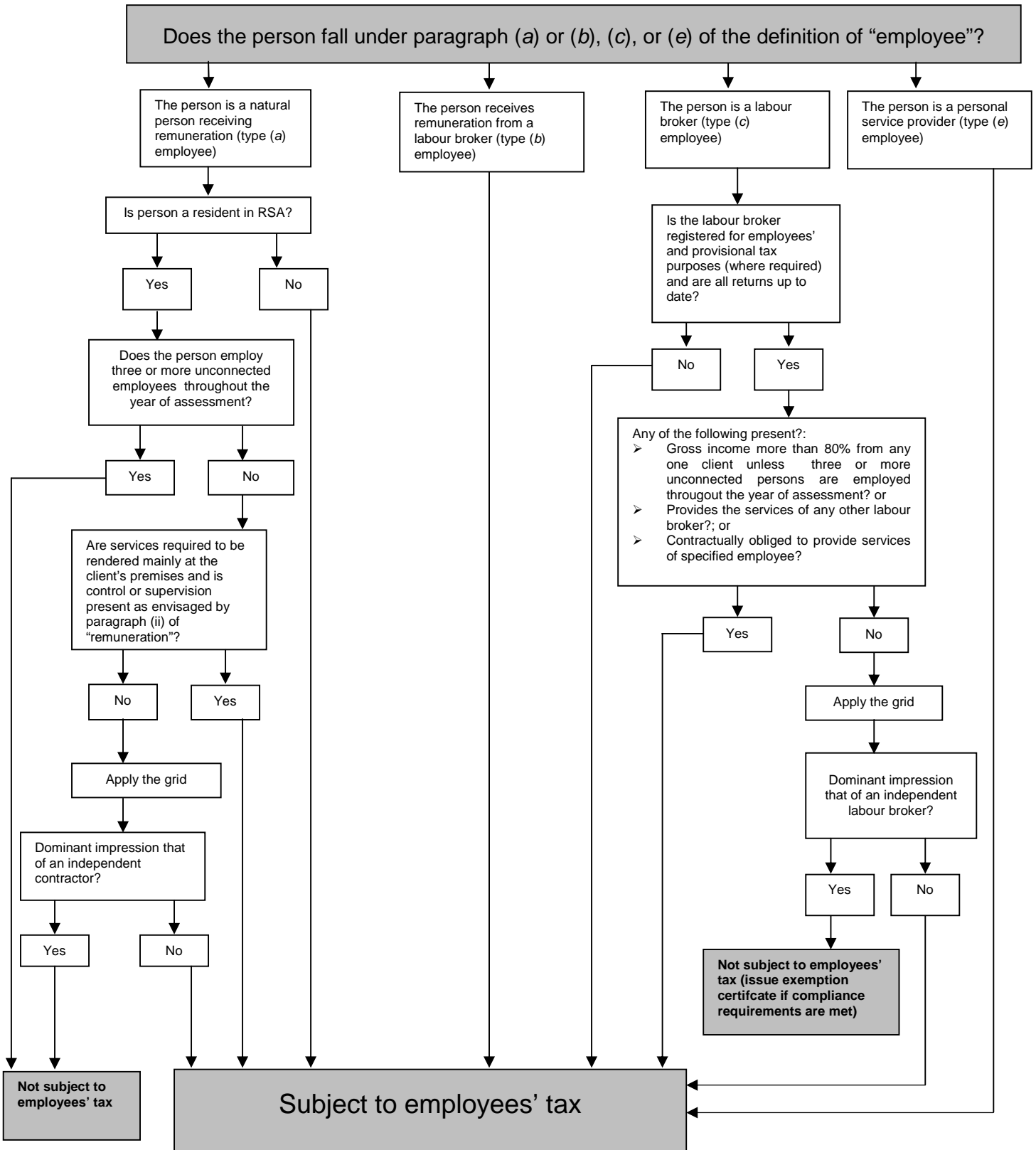
- i) a company or close corporation, employees' tax at the rate of 33% must be withheld by the client (employer) of the company or close corporation; or
- ii) a trust, employees' tax must be withheld by the client (employer) at the rate applicable to trusts (other than special trusts) which is currently 40%.

#### **9. Conclusion**

The information contained in this Interpretation Note covers the main aspects associated with personal service providers, personal service trusts and labour brokers.

**Legal and Policy Division**  
**SOUTH AFRICAN REVENUE SERVICE**  
**Date of first issue: 7 March 2006**  
**Date of second issue: 11 December 2007**

**Annexure A – Flow diagram**



**Annexure B – Personal service provider process flow**

