

A critical analysis of a non-executive director's responsibility to register and account for VAT

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ABSTRACT

Complexities and uncertainty normally arise when the application of a provision in one Tax Act is dependent on a provision in another Tax Act. This is especially true when a person's liability to register and account for VAT is dependent on his or her classification as an employee in receipt of "remuneration" as defined in paragraph 1 of the Fourth Schedule to the Income Tax Act (58 of 1962).

Uncertainty exists whether or not a non-executive director is liable to register and account for VAT. This is firstly due to the contentious nature of the non-executive director's classification either as an employee or independent contractor and secondly the uncertainty if the non-executive director's duties will constitute an "enterprise," as defined in section 1(1) of the VAT Act.

Guidance is necessary in order to provide certainty to non-executive directors regarding their obligation to register and account for VAT.

The main objective of this study was to determine whether there may, in principle, be VAT and employee's tax consequences on fees earned by non-executive directors and to suggest practical solutions for the identified uncertainties. The research method followed was normative, which is a form of legal research, specifically doctrinal. This was chosen because the object of such research is not just to gather information, but also to point out in which aspects the object of study may be improved and to investigate the possibilities for improvement.

Therefore the definition of a non-executive director and the characteristics that distinguish a non-executive director from an executive director were identified and explored. This evaluation, as well as an analysis of the requirements to be classified either as an independent contractor or employee, was crucial to determine the correct classification of the non-executive director. The impact of this classification on the non-executive director's liability in terms of South Africa's current VAT system to register and account for VAT was also considered and analysed. The liability of non-executive directors in New Zealand to register and levy GST was also analysed and discussed. The information obtained was used to establish how the interpretational problems and uncertainties that were identified during the research are dealt with in New Zealand.

A final conclusion was formulated and practical solutions for the identified uncertainties were suggested after an in-depth reflection of each chapter's research result. It was found that strong evidence exists to support the classification of a non-executive director as an independent contractor. Flowing from this finding it could be argued in theory that employees' tax cannot be withheld from non-executive directors' fees and that non-executive directors may have to register and account for VAT should the value of the fees earned exceed R1 million over a twelve-month period.

In practice this finding places a heavy administrative burden on both SARS and the non-executive director, whilst no additional tax revenues are generated for the state from a VAT perspective. It is due to the fact that the output VAT charged by the non-executive director is cancelled out by the input VAT claim of the company for which the independent advisory services were rendered.

The practical solution with the same end result is to exclude the services of a director from the "enterprise" definition for VAT purposes. This practical solution is in line with New Zealand's current practice and law.

With regards to normal income tax it was found that the current method of collecting income tax on non-executive directors' fees (i.e. provisional tax) has the shortcoming that the tax is not collected as and when the fees are payable. It is, however, not recommended that a new type of withholding tax, similar to New Zealand's "tax on schedular payments," should be implemented.

The most practical solution is to consider current mechanisms available. It is suggested that the "remuneration" definition, as per paragraph 1 of the Fourth Schedule to the Income Tax Act, should be amended to specifically include directors' fees even if the director is classified as an independent contractor. This will ensure the timely collection of taxes. From a non-executive director's point of view it is submitted that this proposed amendment will not have negative tax consequences. It is not anticipated that such persons will incur material business-related expenses which might be denied in terms of section 23(m) of the Income Tax Act, should National Treasury implement the proposed amendment. This is due to the fact that the biggest component of the independent advisory services rendered by non-executive directors is actually their own time spent. There is in any case no tax deduction available for a person's own time spent in the production of their income.

KEYWORDS

Activity, Continuous, Employees' tax, Enterprise, Independent contractor, Non-executive director, Regularly, Remuneration, Value-added tax.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS	i
ABSTRACT.....	ii
KEYWORDS.....	iv
TABLE OF CONTENTS	v
ABBREVIATIONS.....	viii
CHAPTER 1.....	1
INTRODUCTION	1
1.1 BACKGROUND AND LITERATURE REVIEW OF THE RESEARCH AREA	1
1.2 MOTIVATION FOR CHOOSING THE TOPIC.....	2
1.3 RESEARCH QUESTION.....	3
1.4 OBJECTIVES.....	3
1.4.1 Primary objective	3
1.4.2 Secondary objectives.....	3
1.5 RESEARCH DESIGN AND METHODOLOGY.....	4
1.5.1 Research design.....	4
1.5.2 Research methodology	4
1.6 STRUCTURE AND OVERVIEW.....	5
1.6.1 Chapter 1.....	5
1.6.2 Chapter 2.....	5
1.6.3 Chapter 3.....	5
1.6.4 Chapter 4.....	6
1.6.5 Chapter 5.....	6
1.6.6 Chapter 6.....	6
CHAPTER 2.....	7
NON-EXECUTIVE DIRECTORS' ROLES AND RESPONSIBILITIES	7
2.1 INTRODUCTION.....	7
2.2 THE DEFINITION OF A NON-EXECUTIVE DIRECTOR AND ITS ROLES AND RESPONSIBILITIES IN TERMS OF THE KING REPORT ON CORPORATE GOVERNANCE ...	8
2.2.1 Background.....	8
2.2.2 Enforceability of the King Report on Corporate Governance	8
2.2.3 Definition and characteristics of a non-executive director	9
2.2.4 Roles and responsibilities of a non-executive director	10
2.3 ROLES AND RESPONSIBILITIES OF A NON-EXECUTIVE DIRECTOR IN TERMS OF THE COMPANIES ACT AND SOUTH AFRICAN COMMON LAW	11
2.3.1 Duties in terms of the Companies Act	11
2.3.2 Duties in terms of South African common law	13
2.4 CONCLUSION	14
CHAPTER 3.....	15
NON-EXECUTIVE DIRECTORS AND EMPLOYEES' TAX.....	15

3.1 INTRODUCTION	15
3.2 FUNDAMENTAL PRINCIPLES AND PURPOSE OF EMPLOYEES' TAX AND PROVISIONAL TAX	16
3.2.1 Purpose	16
3.2.2 Fundamental principles of employee's tax and provisional tax	16
3.3. CLASSIFICATION OF NON-EXECUTIVE DIRECTORS	17
3.3.1 Current legislation	17
3.3.2 Meaning of the term "independent contractor"	20
3.3.3 Classification of a non-executive director as an employee or independent contractor ...	21
3.4 CONCLUSION	28
CHAPTER 4.....	30
AN ANALYSIS OF THE ENTERPRISE DEFINITION AND THE INTERACTION THEREOF WITH THE REMUNERATION DEFINITION.....	30
4.1 INTRODUCTION	30
4.2 FUNDAMENTAL PRINCIPLES OF VALUE-ADDED TAX.....	30
4.3 REGISTRATION REQUIREMENTS	31
4.3.1 Compulsory registration	32
4.4 DEFINITION OF ENTERPRISE.....	33
4.4.1 Any enterprise or activity	33
4.4.2 Carried on continuously or regularly	34
4.4.3 In the course or furtherance of which services are supplied to any other person	37
4.4.4 For a consideration	37
4.5 THE IMPLICATIONS OF THE PROVISO TO THE "ENTERPRISE" DEFINITION AND THE INTERACTION THEREOF WITH THE FIRST PROVISO TO PARAGRAPH (ii) OF THE "REMUNERATION" DEFINITION	38
4.6 CONCLUSION	40
CHAPTER 5.....	41
DIRECTORS' FEES AND GOODS AND SERVICES TAX (GST) IN NEW ZEALAND	41
5.1 INTRODUCTION	41
5.2 BASIC GST AND EMPLOYEES' TAX PRINCIPLES IN NEW ZEALAND	41
5.3 CLASSIFICATION OF THE NON-EXECUTIVE DIRECTOR IN TERMS OF NEW ZEALAND LAW	42
5.4 DIRECTORS' FEES AND GOODS AND SERVICES TAX (GST)	43
5.4.1 Compulsory registration threshold in New Zealand to be liable and to account for Goods and Services Tax	44
5.4.2 The requirements to classify as a "taxable activity"	44
5.4.3 Accepting the office in carrying on that taxable activity.....	47
5.4.4 The applicability of the Public Ruling, BR PUB 15/10, on non-executive directors.....	49
5.5 DIRECTORS' FEES AND TAX ON SCHEDULAR PAYMENTS.....	49
5.6 DIRECTORS' FEES AND EMPLOYEES' TAX	50
5.7 CONCLUSION	51
CHAPTER 6.....	54
CONCLUSION AND RECOMMENDATIONS.....	54

6.1 INTRODUCTION.....	54
6.2 ACHIEVEMENT OF RESEARCH OBJECTIVES AND CONCLUSIONS REACHED.....	55
6.3 CONCLUSION AND RECOMMENDATIONS	59
REFERENCES	61

ABBREVIATIONS

GST	Goods and Services Tax
JSE	Johannesburg Stock Exchange
NEDLAC	National Economic Development and Labour Council
PAYE	Pay-as-you-earn
PwC	PricewaterhouseCoopers
SAICA	South African Institute of Chartered Accountants
SAIT	South African Institute of Tax Professionals
SARS	South African Revenue Services
VAT	Value-added Tax
EY	Ernst and Young

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND AND LITERATURE REVIEW OF THE RESEARCH AREA

One of the basic principles of any tax system is that individuals must have certainty regarding the tax payable by them (Smith & Joyce, 1797:259). Complexities and uncertainty often arise when the application of a provision in one Tax Act is dependent on a provision in another Tax Act, such as the treatment of employees in receipt of “remuneration” as defined in paragraph 1 of the Fourth Schedule to the Income Tax Act 58 of 1962 under the Value-Added Tax Act 89 of 1991 (Kruger, 2015:1).

Due to this uncertainty exists whether or not a non-executive director is liable to register and account for Value-Added Tax.

Firstly, is it uncertain whether or not non-executive directors carry on a trade independently of the company they are directors of. This is due to the fact that their typical roles and responsibilities contain elements that may suggest both employee and independent contractor statuses. The issue of whether a person is employed as an employee or carrying on a trade independently of the person paying the remuneration is regarded as a grey area in South African tax law (Dann, 1998:2; De Koker & Williams, 2016).

The fact that the typical non-executive director has to personally provide his services and not being able to delegate his responsibilities may in terms of our common law suggest employee status. However, the third King Report on Corporate Governance for South Africa requires that an independent non-executive director must be free from any relationship which could be seen by an objective outsider to interfere materially with the individual’s capacity to act in an independent manner (King, 2009:50). The very nature of the role of the non-executive director suggests that they must operate independently from the organisation they serve (La Grange & Comninos, 2012; Van Schalkwyk & Nel, 2013:406).

Secondly, according to the Value-Added Tax Act an enterprise is essentially engaging in “continuous or regular activity.” This term is not defined in the Value-Added Tax Act and no case law currently exists to clarify the meaning thereof in the context of non-executive directors’ services (Institute of Directors Southern Africa, 2016:17). It is uncertain if the services of the non-executive directors, such as the attendance of regular board meetings,

will fall within the ambit of the term. It is also uncertain if South African courts will support the views as set in New Zealand's case law.

Thirdly, uncertainties arise due to difference in wording of paragraph (iii)(*bb*) of the proviso to the "enterprise" definition and the first proviso to paragraph (ii) of the "remuneration" definition as per the Value-Added Tax Act and Income Tax Act respectively. These two paragraphs make provision for the exclusion of so called "independent contractors" for employees' tax and VAT purposes, but the exclusion in the "enterprise" definition is less circumscribed (Kruger, 2015:1). This has resulted in a situation where an independent contractor may fall within the definition of an enterprise, even if the fees were regarded as "remuneration" for employees' tax purposes (Kruger, 2015:11; Stigling *et al.*, 2013:1093).

Such office holders are therefore exposed to unnecessary risks such as penalties and interest running into hundreds of thousands of rands in case of incorrect interpretation.

1.2 MOTIVATION FOR CHOOSING THE TOPIC

The impact on non-executive directors in practice could be far reaching. With reference to companies listed on the Johannesburg Securities Exchange (JSE), it was noted that 66% of all directors are non-executive directors and the number of non-executive directors of these companies has increased by 13.2% since 2002 (PwC, 2012:26).

Therefore, considering the number of non-executive directors currently in South Africa and the contentious nature of the issue whether the services rendered will fall within the ambit of the enterprise definition or not, there is a need to achieve greater clarity.

Furthermore is it anticipated that non-executive directors who received fees and other consideration exceeding R1 million in a 12-month period and failed to register for Value-Added Tax (VAT) could face a VAT liability, penalties and interest running into hundreds of thousands of rands.

The Minister of Finance also indicated in his budget speech for 2016/17 that this is an area that will be scrutinised in the coming tax year.

1.3 RESEARCH QUESTION

Due to the uncertainties that exist, the study was undertaken to address the following research question: Must there in principle be value-added tax and employees' tax consequences on fees earned by non-executive directors and if so, in which circumstances?

1.4 OBJECTIVES

To address the problem statement in paragraph 1.3 above the following objectives are formulated to answer the research question.

1.4.1 Primary objective

To determine whether there may be in principle value-added tax and employees' tax consequences on fees earned by non-executive directors and to suggest practical solutions for the identified uncertainties.

1.4.2 Secondary objectives

In addition to the main objective, the study is directed by secondary objectives:

- i) To identify and analyse the roles and responsibilities of non-executive directors to determine what sets them apart from executive directors (refer to chapter 2);
- ii) to identify and explore the requirements to be classified either as an independent contractor or employee and whether the fees paid to non-executive directors may in principle constitute "remuneration" as defined in the Fourth Schedule to the Income Tax Act 58 of 1961 (refer to chapter 3);
- iii) to analyse the definition of enterprise and to identify the challenges regarding interpretation as well as uncertainties experienced with regards to the application thereof to a scenario where a non-executive director renders services, as required by King III, to the company he/she is a director of (refer to chapter 4);
- iv) to analyse the requirements applicable to a non-executive director to register as a vendor and for levying GST in New Zealand. To identify how the interpretation problems and uncertainties that have been identified in chapter 3 and 4 are dealt with in New Zealand, to make recommendations whether or not there must be value-added tax consequences in South Africa and to justify the findings as documented in this study (refer to chapter 5).

1.5 RESEARCH DESIGN AND METHODOLOGY

1.5.1 Research design

The research design sets out the overall approach as to how the research will be conducted (Hofstee, 2011:113). The research question could be attended to by referencing already published data. A non-empirical study approach was followed in the research conducted (Mouton, 2013:179).

The data available included text documents, as well as documents and articles published on websites. Therefore a literature review was performed (Mouton, 2013:179-180). A literature review is “an exercise in inductive reasoning,” where a sample of literature is selected and read to be able to come to an understanding of the object of the study (Mouton, 2013:179).

The said review was performed to provide the data used to undertake the normative method of study, which is a form of legal interpretive research. The data consisted mainly of primary data; limited use was made of secondary data sources. Primary data refers to “data observed or collected directly from first-hand experience,” whereas secondary data refers to “data collected in the past” or by other parties (Business Dictionary, 2016).

1.5.2 Research methodology

Any research methodology is a detailed explanation of the specific use of the research design (Hofstee, 2011:115). The type of ontology (how the world is viewed) and epistemology (how knowledge is created) influences the choice of paradigm within which the research will be conducted (McKerchar, 2008). The research was done based on the view that reality depends on many circumstances and factors and with the perspective that tax is complex and that different interpretations may be possible. The research was therefore conducted with a relativist view of the world in the interpretivist paradigm, which is “based on the assumption that the researcher cannot be detached from the subjects being studied” and that, depending on the researcher’s perspective, there may be different solutions (McKerchar, 2008).

The research method followed was normative, which is a form of legal research, specifically doctrinal. This was chosen because the object of such research is not just to gather information, but also to point out in which aspects the object of the study may be improved

and to investigate the possibilities for improvement (Routio, 2005). Doctrinal research is a research methodology that provides a “systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary. It is typically a library based undertaking, focused on reading and conducting intensive, scholarly analysis” (McKerchar, 2008).

The normative research method was applied to identify the VAT requirements and to determine how the VAT legislation is applied in South Africa, in respect of the levying of and registration for VAT and the definition of enterprise in the VAT Act.

Various local publications and legislations and certain New Zealand publications and legislations were selected to address the research question and objectives. The latter was used firstly due to the fact that the South African Value-Added Tax Act was based on the New Zealand’s GST Act and secondly that New Zealand also experienced interpretation difficulties with regards to the correct treatment of non-executive director fees.

1.6 STRUCTURE AND OVERVIEW

The mini dissertation will consist of the following chapters listed below:

1.6.1 Chapter 1

Chapter 1 supplies the background and motivates the actuality of the taxation of non-executive director fees, especially from a Value-Added Tax perspective. This chapter also describes the research question, objectives and the research methodology.

1.6.2 Chapter 2

Chapter 2 provides an overview of King III’s principles regarding the definition and duties of a non-executive director. Current legislation is also considered to identify the statutory roles and responsibilities of a non-executive director. It is also considered if the statutory roles and responsibilities of the latter differ from those of an executive director.

1.6.3 Chapter 3

Chapter 3 identifies and explores the requirements to be classified either as an independent contractor or employee and if the fees paid to non-executive directors constitute “remuneration” as defined in the Fourth Schedule to the Income Tax Act (58 of 1961). Each of the main elements to test if a person is an employee is explored in more detail, i.e.

independence test, the premises test, the control or supervision test and the dominant impression test. The chapter also identifies uncertainties experienced.

1.6.4 Chapter 4

Chapter 4 analyses the definition of enterprise and the interaction thereof with remuneration as defined in the Fourth Schedule to the Income Tax Act. There is a specific focus on what will constitute a “continuous or regular activity.” This chapter also sets out the importance of when a person is required to register for VAT and to levy output VAT in the Republic. The chapter also identifies uncertainties experienced.

1.6.5 Chapter 5

Chapter 5 analyses the New Zealand interpretation notes, legislation and case law to identify the manner in which the interpretational uncertainties (as identified in chapter 3 and 4) are dealt with in that country and to make recommendations whether or not there must be value-added tax consequences in South Africa and to justify the findings as documented in this study.

1.6.6 Chapter 6

Chapter 6 summarises the results of the research conducted and concludes whether the research objectives (as mentioned in chapter 3. above) have been met in order to address the research question.

CHAPTER 2

NON-EXECUTIVE DIRECTORS' ROLES AND RESPONSIBILITIES

2.1 INTRODUCTION

“Do not hover always on the surface of things, nor take up suddenly with mere appearances; but penetrate into the depth of matters, as far as your time and circumstances allow, especially in those things which relate to your profession” (Watts *et al.*, 1819: 21).

These wise words of almost two centuries ago are still applicable today, especially to non-executive directors. After a series of industry and corporate scandals around the world, several codes regarding corporate governance were developed. These codes, like King III, have laid down more duties and responsibilities on the shoulders of non-executive directors who now bear frontline responsibility for ensuring good corporate governance and accountability (Brown, 2015: 1).

In this chapter an overview is provided of King III's principles regarding the definition and duties of a non-executive director (refer to 2.2). Secondly, current legislation will be considered to identify the statutory roles and responsibilities of a non-executive director. It is also considered if the statutory roles and responsibilities of the latter differ from those of an executive director (refer to 2.3).

It is important to establish what exactly a non-executive director is by definition and what distinguishes a non-executive director from an executive director, as it will form the cornerstone for the classification of the non-executive director as an employee or independent contractor (chapter 3) and consequently if the non-executive director's services constitute an “enterprise” (chapter 4) as this may cause the services rendered to be subject to VAT.

This addresses the research objective, as stated in 1.4.2, namely to identify and analyse the roles and responsibilities of non-executive directors to determine what sets them apart from executive directors.

2.2 THE DEFINITION OF A NON-EXECUTIVE DIRECTOR AND ITS ROLES AND RESPONSIBILITIES IN TERMS OF THE KING REPORT ON CORPORATE GOVERNANCE

2.2.1 Background

The Companies Act (71 of 2008) makes no specific distinction between the responsibilities of executive, non-executive or independent non-executive directors (Deloitte, 2013:5).

In order to understand the distinction between different types of directors, a person should turn to the King Report on Corporate Governance in South Africa, 2009 (King III) for guidance (Deloitte, 2013:5).

As this code is not legally binding (Cliffe Dekker Hofmeyr, 2016:3; Deloitte, 2009:1) it is, for the purposes of this study, important to determine the enforceability of this code.

2.2.2 Enforceability of the King Report on Corporate Governance

2.2.2.1 State-owned entities

King III is binding on all state-owned entities. This was confirmed in the South African court case of South African Broadcasting Corporation Ltd and Another v Mpofo (2009) where the high court considered the principles expounded by King to be binding on state-owned entities.

2.2.2.2 JSE-listed companies

All JSE-listed companies must in terms of paragraph 3.84 of the JSE listing requirements comply with King III on a “comply or explain” basis (JSE, 2016:49-51).

Paragraphs 8.63(a)(ii) and 8.63(l) of the JSE listing requirements also state that listed entities must include a statement in their annual reports addressing the extent of their application of the principles of the King Code and the reasons for each and every instance of non-application during the accounting period. The statement must also specify whether or not the company has applied all the principles of the King Code throughout the accounting period; they must also indicate for what part of the period any non-application occurred (JSE, 2016:129).

2.2.2.3 Other entities

Other entities, such as private companies, are not required to adopt and apply the principles laid down in King III as the latter is not legally binding (Cliffe Dekker Hofmeyr, 2016:3; Deloitte, 2009:1). It is, however, highly recommended that these companies apply and adopt King III principles as it will constitute good governance (Bowman Gilfillan 2009: 2; King, 2009:19). It must also be borne in mind that King III will be used as the court's blueprint to measure the directors' conduct against (Minister of Water Affairs and Forestry v Stilfontein Gold Mining Company Limited and Others, 2006).

It is therefore concluded that King III is suitable to determine the roles and responsibilities of non-executive directors.

2.2.3 Definition and characteristics of a non-executive director

Annexure 2.3 of the King Report on Corporate Governance in South Africa, 2009 (King III) defines a non-executive director as follows:

“Non-executive director:

The non-executive director plays an important role in providing objective judgement independent of management on issues facing the company.

Not being involved in the management of the company defines the director as non-executive.

Non-executive directors are independent of management on all issues including strategy, performance, sustainability, resources, transformation, diversity, employment equity, standards of conduct and evaluation of performance.

The non-executive directors should meet from time to time without the executive directors to consider the performance and actions of executive management.

An individual in the full-time employment of the holding company is also considered a non-executive director of a subsidiary company unless the individual, by conduct or executive authority, is involved in the day-to-day management of the subsidiary.”

The characteristics of a non-executive director are as follows:

- i) The non-executive director is not employed by the company, present or past;
- ii) the non-executive director is not a retained professional advisor that is influenced by his/her fee;
- iii) the non-executive director is not a supplier or customer of the company;
- iv) the non-executive director has no family connections with someone in the company or group;
- v) there is no significant dependence on his director's fee from the company; and
- vi) the non-executive director's ability to resign is a test of independence.

(Cassim *et al.*, 2012: 479; Grant Thornton, 2010).

2.2.4 Roles and responsibilities of a non-executive director

The roles and responsibilities of a non-executive director, based on the definition as per King III (refer to 2.2.3), are as follows:

2.2.4.1 Independence

The non-executive director must be independent on issues such as strategy, performance, sustainability, resources, transformation, diversity, employment equity, standards of conduct and evaluation of performance (Deloitte, 2013:13). This will enable the non-executive director to act as a watchdog and whistle blower ensuring adherence to good practice, respect for the interest of other stakeholders and adherence to the process of boardroom discipline (Gauteng Law Council, 2016).

2.2.4.2 Advisory role

In the Fisheries Development Corporation of SA Ltd v Jorgensen (1980) and Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd (1979a) cases the courts stated that non-executive directors are not bound to give continuous attention to the affairs of the company and that their duties are of an intermittent nature to be performed at periodical board meetings.

In practice it is required from a non-executive director to be an active contributor by attending meetings and to provide critical and meaningful input into matters affecting the company (Institute of Directors Southern Africa, 2011:6; PwC, 2012:8). They must also challenge the thinking of the board of directors as non-executive directors will be able to offer different

perspectives due to their past experience together with their distance from the day-to-day running of the company (La Grange & Comninos, 2012; Roberts *et al.*, 2005:10).

The advisory role is, however, not limited to the board only. It is also expected from the non-executive director to constructively challenge management to ensure that long term objectives and strategies are met and achieved respectively (Seegers, 2008:28-29).

2.3 ROLES AND RESPONSIBILITIES OF A NON-EXECUTIVE DIRECTOR IN TERMS OF THE COMPANIES ACT AND SOUTH AFRICAN COMMON LAW

2.3.1 Duties in terms of the Companies Act

The statutory duties of a director, in terms of the Companies Act (71 of 2008), are as follows:

2.3.1.1 Fiduciary duty and the duty of reasonable care (section 76(2))

A director's fiduciary duty means that he or she must exercise the powers and perform the functions of a director in good faith and in the best interest of the company. A director must not use the position, or any information obtained as director, for personal gain, nor advantage of any other person other than the company itself. The fiduciary duty also implies that a director may not cause harm to the company (Armstrong *et al.*, 2013:3; Geach, 2009:12).

It should be noted that the duties imposed under section 76 are in addition to, and not in substitution for, any duties of the director of company under the common law. This means that the courts may still have regard to the common law, and past case law when interpreting the provisions of the Act (Deloitte, 2013:23). Refer to 2.3.2 for a summary of a director's common law duties.

2.3.1.2 The duty to act with care, skill and diligence (section 76 (3))

The Companies Act has partially codified the duty of skill and care. An objective test is applied to determine what the reasonable director would have done in the same situation, but there is also a subjective element in that the general knowledge, skill and experience of the particular director in question are taken into account. Section 76(3) thus provides that a director must act with the degree of care and skill (1) that may reasonably be expected of a person carrying out the functions of a director and (2) having the general knowledge, skill and experience of that director (Geach, 2009:12; Tshepo, 2010:267-269).

2.3.1.3 Duty to ensure that the financial statements are not misleading (section 214)

The Companies Act (71 of 2008) provides that it is an offence for a company, with an intention to deceive or mislead any person, to fail to keep accurate or complete accounting records or to keep records other than in the prescribed manner or form (PwC, 2011a:5).

The Act further provides that a person will be guilty of an offence if that person is a party to the preparation, approval, dissemination or publication of any financial statements that fail in a material way to comply with certain requirements in the Act, or are materially false or misleading. This offence is subject to Section 214(2) – False statements, reckless conduct and non-compliance (Geach, 2009:14; PwC, 2011a:5).

2.3.1.4 Duty to ensure that the company is both liquid and solvent (section 44-48)

The new Companies Act itself puts great emphasis and importance on the concepts of 'liquidity and solvency.' The Companies Act (71 of 2008) provides that the solvency and liquidity test must be applied by the board in each of the following circumstances:

- i) When a company wishes to provide financial assistance for subscription of its securities in terms of section 44;
- ii) if a company grants loans or other financial assistance to directors as contemplated in section 45;
- iii) before a company makes any distribution as provided for in section 46;
- iv) if a company wishes to issue capitalisation shares in terms of section 47; and
- v) if a company wishes to acquire its own shares as provided for in section 48 (Geach, 2009:14-15).

The application of the test will predominantly be the prerogative of the directors of the relevant company (Pretorius *et al.*, 2010). In applying the test, the directors will be required to consider "all reasonably foreseeable financial circumstances of the company at that time" (section 4(2)(b)). This implies a predictive element requiring the directors to consider matters which may not be reflected in the accounting records and financial statements of the company, but are rather based on elements such as how the economy or political circumstances may impact on the financial state of the company in the future (Cassim *et al.*; 2012: 273).

It is important to note that the Companies Act refers to "directors." It therefore also includes the non-executive director. In *CyberScene Ltd and others v i-Kiosk Internet and Information*

(Pty) Ltd (2000), the court confirmed that a director stands in a fiduciary relationship to the company of which he or she is a director, even if he or she is a non-executive director.

In Howard v Herrigel (1991a) the court stated that it is unhelpful and even misleading to classify company directors as “executive” and “non-executive” for purposes of ascertaining their duties to the company, or when any or specific or affirmative action is required of them and that no such distinction is to be found in any statute.

It is therefore concluded that there is no difference between the statutory roles and responsibilities of non-executive directors compared to those of executive directors.

2.3.2 Duties in terms of South African common law

A director’s common law duties are basically the same as the fiduciary duty and the duty of reasonable care as per section 76(2) of the Companies Act.

Directors are, amongst other things, required to individually and collectively exercise their powers *bona fide* in the best interest of the company (Howard v Herrigel, 1991a; Treasure Trove Diamonds Ltd v Hyman, 1928), and to act with unfettered discretion (PPWAWU National Provident Fund v Chemical, Energy, Paper, Printing, Wood and Allied Workers’ Union, 2008b).

Directors are also prohibited to allow their personal interests to interfere with their duties, to make secret profits (Robinson v Randfontein Estates Gold Mining Co Ltd, 1921) and to compete with the company (Cyberscene Ltd and Others v i-Kiosk Internet and Information (Pty) Ltd, 2000).

There is no distinction between the common law duties of a non-executive director compared to those of the executive director. This principle was established in the CyberScene Ltd and others v i-Kiosk Internet and Information (Pty) Ltd (2000) and Howard v Herrigel (1991a) cases.

2.4 CONCLUSION

The following two characteristics were identified that set the non-executive director apart from an executive director, namely to be independent in all material aspects and to act as an advisor of the board and management.

It was noted that these differences had no impact on the statutory and common law duties of the non-executive director compared to those of an executive director.

The impact of these findings on the classification of the non-executive director as an employee or independent contractor, as well as the question if the non-executive director's services constitute an "enterprise" or not, is evaluated in chapter 3 and 4 respectively.

CHAPTER 3

NON-EXECUTIVE DIRECTORS AND EMPLOYEES' TAX

3.1 INTRODUCTION

It was concluded in the previous chapter that it is required from a non-executive director to be independent and to act as an advisor of the board and management of the company.

The fact that it is required from a non-executive director to be independent and to act as an advisor does not *per se* indicate that he or she is an independent contractor. It may, however, strengthen the case for a non-executive director to be classified as an independent contractor (Van Schalkwyk & Nel, 2013: 406).

The objective of this chapter is to determine the impact of the findings documented in chapter 2, if any, on the classification of the non-executive director as an employee or independent contractor (refer to 3.3 below).

Firstly, an overview of the fundamental principles and purpose of employees' tax and provisional tax are provided to establish whether in principle there should be employees' tax consequences on the fees earned by non-executive directors.

Secondly, the current legislation, case law and guidance from the South African Revenue Services will be considered to identify and apply the tools available to determine whether there should be employees' tax consequences or not on the fees earned by non-executive directors.

This addresses the research objective as stated in 1.4.2: to identify and explore the requirements to be classified either as an independent contractor or employee and whether the fees paid to non-executive directors may in principle constitute "remuneration" as defined in the Fourth Schedule to the Income Tax Act (58 of 1961).

3.2 FUNDAMENTAL PRINCIPLES AND PURPOSE OF EMPLOYEES' TAX AND PROVISIONAL TAX

3.2.1 Purpose

Employees' tax and provisional tax are not separate taxes. It is in essence a manner to collect the normal income tax due by taxpayers on wages and business income respectively (SARS, 2016a:3; Stiglingh *et al.*, 2015: 450; Thuronyi, 1998b: 564).

The employees' tax method would allow the tax administration to collect a large share of the personal income tax without wasting administrative resources, as the administrative burden rests on employers who must file monthly and pay the withheld tax on a monthly or more frequent basis (Grant Thornton Kessel Feinstein, 1999). Because of PAYE, more administrative resources can be deployed in those areas where tax revenue is more at risk than in wage withholding (Thuronyi, 1998b: 565).

The object of the provisional tax system, on the other hand, is to require businesses to pay tax on a regular basis throughout the year as income is derived, not when final liability is determined after the end of the tax year (SARS, 2016a:4; Thuronyi, 1998b: 667).

3.2.2 Fundamental principles of employee's tax and provisional tax

PAYE is only applicable to income generated from "continuing service relationships where most or a significant part of the service provider's income is derived from one customer and that income essentially represents remuneration for the service provider's labour" and not on "profits generated from a commercial or industrial activity of an independent nature undertaken for profit." The latter will include independent contractor relationships, i.e., relationships that are within the ordinary meaning of business (Grant Thornton Kessel Feinstein, 1999; Thuronyi, 1998b: 598).

According to the International Monetary Fund's principles regarding tax law design the employment definition must be coordinated with the definition of business so that the same economic activity is not characterised as both a business and an employment for income tax purposes (Thuronyi, 1998b: 599).

Based on the fundamental principles of employees' tax it can be argued that PAYE can only be withheld by the company in principle if the fees earned by the non-executive director are generated from a continuing service relationship, where most or a significant part of the non-executive director's income is derived from one customer (refer to 3.3.3.3 Client base) and that income essentially represents remuneration for the non-executive director's labour (refer to 3.3.3.3 Nature of obligation to work).

On the other hand will non-executive directors be responsible to determine the amount of tax due on the fees earned and for making instalment payments (i.e. provisional tax payments) at designated times if it can be argued that the fees were generated from "a commercial activity of an independent nature undertaken for profit" (Thuronyi, 1998b: 666).

Another key characteristic of provisional tax payers (i.e. independent contractors) that sets them apart from employees is the deductibility of expenses incurred for the purposes of the taxpayer's trade (Croome, 2010:90). In principle all costs incurred to derive business income should be recognised for the purpose of determining taxable income (Thuronyi, 1998b: 666).

Salaried employees, on the other hand should, in principle, be taxed on income before consumption (Croome, 2010:96). This is based on the fact that employers will, in basically all circumstances, provide the facilities or means to render the services (Croome, 2010:90).

It could be advantageous for the non-executive director to be classified as an independent contractor. All costs incurred to derive business income should be deductible in determining taxable income. This may not be the case if the non-executive director is classified as an employee.

3.3. CLASSIFICATION OF NON-EXECUTIVE DIRECTORS

3.3.1 Current legislation

The fundamental principles of employees' tax, as stated in 3.2.2 above, are incorporated in the Fourth Schedule to the Income Tax Act. An "employer-employee" relationship must exist and the amount must be "remuneration" before employees' tax can be deducted from that amount (paragraph 2(1) of the Fourth Schedule to the Income Tax Act (58 of 1961)).

The “employee” and “remuneration” definitions in the Fourth Schedule to the Income Tax Act (58 of 1961) have to be consulted in order to determine whether there should be employees’ tax consequences or not on the fees earned by non-executive directors.

The “employee” definition is as follows:

“For the purposes of this Schedule, unless the context otherwise indicates –

“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; or*
- f) **[deleted by the Revenue Laws Amendment Act No. 60 of 2008]; and***
- g) any director of a private company who is not otherwise included in terms of paragraph (a).”*

A non-executive director could be classified as an employee either in terms of paragraph (a) or (g).

With regards to paragraph (g), it can be argued that is highly unlikely that private companies will as a rule appoint non-executive directors. The reasons are:

- i) Private companies may appoint just one director in terms of the Companies Act, Act 71 of 2008 (Bowman Gilfillan, 2007:175; Cassim, 2011:65);
- ii) although King III (applicable to all entities) requires the appointment of non-executive directors, is it permissible in terms of King III to not comply with the prerequisites as long as the fact is disclosed (PwC, 2009:1); and
- iii) it can be argued that the number of stakeholders, whose interests need protection, are limited due to the statutory restrictions on i) transferability of shares, ii) membership and iii) public offerings (a private company must prohibit any offering of its shares or debentures to the public) (Bowman Gilfillan, 2007:175).

For inclusion in terms of paragraph (a) it must be proved that the fees paid to non-executive directors constitute “remuneration.”

The “remuneration” definition (as far as it is relevant) is as follows:

*“**remuneration**” means 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, whether in cash or otherwise and whether or not in respect of services rendered...*

But not including –

(ii) any amount paid or payable in respect of services rendered or to be rendered by any person (other than a person who is not a resident or an employee contemplated in paragraph (b), (c), (d), (e) or (f) of the definition of “employee”) 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: Provided that for the purposes of this paragraph a person shall not be deemed to carry on a trade independently as aforesaid if the services are required to be performed mainly at the premises of the person by whom such amount is paid or payable or of the person to whom such services were or are to be rendered and the person who rendered or will render the services is subject to the control or supervision of any other person as to the manner in which his or her duties are performed or to be performed or as to his hours of work: Provided further that a person will be deemed to be carrying on a trade independently as aforesaid if he throughout the year of assessment employs three or more employees who are on a full time basis engaged in the business of such person of rendering any such service, other than any employee who is a connected person in relation to such person...”

The “remuneration” definition lists which amounts received constitute remuneration and which amounts are specifically excluded (Paragraph 1 of the Fourth Schedule). A typical non-executive director will receive director’s fees for meetings attended and for the responsibilities undertaken as mentioned in chapter 2, not a salary (Seegers, G. 2008, 28-29). Fees are specifically included in the “remuneration” definition, provided that it is not excluded in terms of exclusion rule (ii) in the “remuneration” definition (i.e. independent contractor exclusion).

To determine if the independent contractor exclusion is applicable to non-executive directors, the meaning of the term “independent contractor” must be established. Refer to 3.3.2 below for a summary of the South African Revenue Services’ view of the meaning of the common law concept “independent contractor.”

3.3.2 Meaning of the term “independent contractor”

SARS sets out in Interpretation Note 17 (Issue 3) the meaning of the common law concept “independent contractor” and provides tests (statutory and common law tests) to appropriately classify a person either as an employee or independent contractor.

Appendix C of the above-mentioned interpretation note states that an independent contractor is merely a synonym for an “entrepreneur”, “employer” or “potential employer” (SARS, 2010: 19).

Firstly, from a common law perspective, the word “independent” in the concept of an “independent contractor” means that the person cannot be controlled by the opinions, regulations and other mechanisms in place by the employer (The Business Dictionary: 2016). This is what ultimately distinguishes an employee from an independent contractor.

The contract between the parties (the non-executive director and the entity) has to be scrutinised to establish whether the contract is *locatio conductio operarum* or *locatio conductio operis*.

Locatio conductio operarum is essentially a relationship where the employee will only make available his or her productive capacity (Calitz 2003: 39; Fourie 1977:20), thereby enabling the acquisition of the service itself and not the fruits of that productive capacity (SARS, 2010: 19-20). Gruner (2005:3-35) confirmed that the following acts are within the scope of employment:

- i) The conduct is of the kind he or she is employed to perform;
- ii) the conduct occurs substantively within the authorised time and space limits; and
- iii) the conduct is actuated, at least in part, by a purpose to serve the employer.

The view as set in point i) to iii) above is also supported by Kondrasuk *et al.* (2001) and Frago and Kleiner (2005:139).

Locatio conductio operis, on the other hand, is in essence a contract to acquire the results of productive capacity, i.e. the hire of completed work (Deakin 2015:178). The contractor is responsible to produce completed work for which he or she had been contracted to produce, whether or not he or she made use of other persons (his or her own employees) to do the work, and whether or not he or she did so personally. In other words, the contractor is responsible for the success of the work. He or she has to face the problem of liability for defects under the contract of work. He or she, generally, would not be under the control and supervision of the client (SARS, 2010:20).

3.3.3 Classification of a non-executive director as an employee or independent contractor

One stumbling block in the classification of a non-executive director as an employee or independent contractor is that it is permissible in terms of King III to not comply with the prerequisite of formal service contracts as long as fact is disclosed (PwC, 2012).

Therefore, as there are no standardised employment contracts for all non-executive directors, it will be considered whether in principle non-executive directors make available their productive capacity or the result of their productive capacity (Van Schalkwyk & Nel, 2013: 407). Thus, the type of contract (i.e. *locatio conductio operarum* or *locatio conductio operis*) is relevant, but not decisive for classification purposes.

To assist employers and SARS officials to classify a worker efficiently and effectively, Interpretation Note 17 (Issue 3) (SARS, 2010:2-3) explains the working of both the common law test and the statutory tests. The tests contained in exclusion rule (ii) should be applied in a specific order as specified in Interpretation Note 17 (Issue 3) (SARS, 2010:3).

To determine whether exclusion rule (ii) is applicable to directors' fees received by non-executive directors, each of the three tests (independence, employee and dominant impression) will now be considered separately in the order specified in Interpretation Note 17 (Issue 3) (SARS, 2010:3).

3.3.3.1 Independence test

Proviso (ii) states:

“Provided further that a person will be deemed to be carrying on a trade independently as aforesaid if he throughout the year of assessment employs three or more employees who are on a full time basis engaged in the business of such person of rendering any such service, other than any employee who is a connected person in relation to such person.”

Both King III and the Companies Act are silent on the right of a non-executive director to delegate his/her responsibilities, but it is highly unlikely based on the nature of their roles and responsibilities as set out in chapter 2, that a non-executive director will be able to delegate the rendering of such services to another person (Van Schalkwyk & Nel, 2013: 410).

It follows that non-executive directors would not conclusively be deemed to be independent contractors in terms of the independence test contained in proviso (ii). Consequently the employee test and dominant impression test must be considered.

3.3.3.2 Employee test

Proviso (i) states:

“Provided that for the purposes of this paragraph a person shall not be deemed to carry on a trade independently as aforesaid if the services are required to be performed mainly at the premises of the person by whom such amount is paid or payable or of the person to whom such services were or are to be rendered and the person who rendered or will render the services is subject to the control or supervision of any person as to the manner in which his or her duties are performed or to be performed or as to his hours of work.”

The employee test comprises two elements, namely the “premises” element and the “control and supervision” element. Both these elements should be present in order for a non-executive director to be classified as an employee (Clegg, 2009; NEDLAC, 2006).

The “premises” element will be applicable if the services are required to be performed mainly at the premises of the person by whom such amount is paid. If the non-executive director has an employment contract with the company and it specifies that the services are not required to be performed mainly at the premises of the company, the premises element would not be in the affirmative (Van Schalkwyk & Nel, 2013:411). It is, however, recognised that some non-executive directors might not even have service agreements with the company (PwC, 2012:24). Therefore, it should be established whether, in principle, a non-executive director performs services mainly at the premises of the company.

The Cambridge Dictionary (2016) defines ‘mainly’ as: “usually or to a large degree.” In *SBI v Lourens Erasmus (Edms) Bpk* (1996b), the court looked at the meanings of the words ‘solely’ and ‘mainly’. The court held that “in the context under consideration, the word ‘mainly’ establishes a purely quantitative measure of more than 50% and the associated use of the word ‘solely’ or mainly is inserted, *ex abundante cautela*, to circumvent the possibility that what may be described as being ‘solely’ of a particular character would not qualify as being ‘mainly’ of that character.”

It is submitted that SARS will assess whether or not the non-executive director performed his or her duties mainly (more than 50%) at a premises other than those of the company on a case-by-case basis, taking all the facts and circumstances into account. This will include a consideration of, among other factors, the nature of the non-executive director's responsibilities and official duties.

In terms of section 102 of the Tax Administration Act (28 of 2011) the non-executive director bears the burden of proof that his or her duties were performed mainly (more than 50%) at a premises other than those of the company.

Only part of a non-executive’s responsibilities (refer to chapter 2) may be required to be performed at the premises of the company such as the physical attendance of meetings as:

- i) It is not necessary for non-executive directors to perform their other services mainly at the premises of the company as it is submitted that the preparations for those meetings, preparations to challenge the board and management and to obtain sufficient knowledge of the business can be performed off-site (Institute of Directors Southern Africa, 2016:8; Seegers, 2008:28-29); and

- ii) due to technological advances made, especially with regards to communication methods and means, is it possible for a non-executive director to “attend” meetings without being physically present at the premises of the company. Section 73(3) of the Companies Act also allows directors, subject to approval, to vote on decisions by means of electronic communication (Deloitte, 2013: 40; PwC, 2011b).

It can therefore be concluded that it will be very unlikely that services rendered by a non-executive director would meet the requirements of the premises element. Hence, as mentioned above, is it therefore not necessary to consider the “control or supervision” element.

If, however, the premises element does apply to a non-executive director, it must be determined whether the control or supervision element is applicable. Interpretation Note 17 (Issue 3) explains both the control and supervision indicators. The control indicator examines the quality of control (meaning whether intended to acquire control of productive capacity), rather than the degree or extent of control (SARS, 2010:8). Non-executive directors should be active contributors by attending meetings and to provide meaningful input (refer to chapter 2). Contribution is also considered as one of the key pillars of the fee-setting process for non-executive directors (PwC, 2012:8). This warrants merit to the argument that non-executive directors are providing their independent input to the management of the company, and in doing so are rewarded for the result of their productive capacity (La Grange & Comninos, 2012; Van Schalkwyk & Nel, 2013: 412). The control indicator will therefore not be present in the case of a non-executive director.

The supervision indicator is explained as the employer controlling the work done and the environment in which the work is done by giving instructions as to the location, when to begin or stop, pace, order or sequence of work (SARS, 2010:11). SARS (2010:11) also indicated that any form of supervision must flow from the legal relationship itself (the contract).

It is highly unlikely that the “supervision” indicator will be present in the case of a non-executive director as:

- i) Non-executive directors do not have employment contracts with the company (refer to 3.3.3 above); and

- ii) the fact that non-executive directors are not supervised by the company (Institute of Directors Southern Africa, 2016:8; La Grange & Comminos, 2012).

It follows that non-executive directors would not conclusively be deemed to be independent contractors in terms of the independence and employee test contained in proviso (ii). Consequently the dominant impression test must be considered.

3.3.3.3 Dominant impression test

The dominant impression test was established in the *Smit v Workmen's Compensation Commissioner* (1979b) case and the key point was that the "control and supervision" test is only one of several indicators to determine if a person is an employee or not.

Furthermore must the inquiry be directed to:

- i) the worker's obligations rather than his or her rights, and
- ii) the extent of the employer's rights to utilise the worker's productive capacity

(*Liberty Life Association of Africa Ltd v Niselow*, 1996a).

Interpretation Note 17 (Issue 3) states that the current South African common law position is that the so-called "dominant impression test" must be applied by an employer to determine whether a worker is an independent contractor or an employee (SARS, 2010:7). The test consists of a non-exhaustive list of common indicators summarised in Annexure B as the Common Law Dominant Impression Test Grid.

The indicators have been classified into three categories, namely:

- i) Near-conclusive (indicative of the acquisition of productive capacity);
- ii) persuasive (establishing the extent of control of the work environment); and
- iii) resonant of either an employee/employer relationship or an independent contractor/client relationship.

Every indicator in the grid contains details which suggest employee status or independent contractor status if applied to the employment relationship between a person rendering services and the employer (SARS, 2010:18). The classification and weighting (as indicated by the significance of the indicator-category) are intended to assist employers to make the determination. The employer must apply the grid as a guide to analyse the employment relationship in the light of all the indicators, and their relative weightings, and arrive at a

dominant impression in favour of either the acquisition by the employer of the worker's productive capacity (effort), or the result of the worker's productive capacity (SARS, 2010:8).

The near-conclusive and persuasive indicators suggesting either employee or independent contractor status, as contained in the common law dominant impression test grid, are now applied to non-executive directors in order to determine whether they would be indicative of independent contractor status or employee status.

The analysis of near-conclusive indicators is as follows:

i) Control of manner of working

Based on the analysis of the roles and responsibilities in chapter 2, there is conclusive evidence that non-executive directors are not instructed or supervised by their company in the routine they must follow in the execution of their duties (Institute of Directors Southern Africa, 2016:8; La Grange & Comninos, 2012; Van Schalkwyk & Nel, 2013: 414).

This indicates "independent contractor" status in terms of Interpretation Note 17 (Issue 3).

ii) Payment regime

A typical South African non-executive director will receive a base fee as well as a fee per meeting (King, 2009: 44; PwC 2012:36). Non-executive directors should also be compensated with reference to their contribution (PwC, 2012:8). This is a strong indicator that it is the result of the non-executive director's productive capacity being bought instead of the productive capacity itself. (La Grange & Comninos, 2012; Van Schalkwyk & Nel, 2013: 412).

This indicates "independent contractor" status in terms of Interpretation Note 17 (Issue 3).

iii) Person who must render the service

Both King III and the Companies Act are silent on the right of a non-executive director to delegate his/her responsibilities but it is highly unlikely, based on the nature of their roles and responsibilities as set out in chapter 2, that a non-executive director will be able to delegate the rendering of such services to another person (Van Schalkwyk & Nel, 2013: 410).

This indicates “employee” status in terms of Interpretation Note 17 (Issue 3).

iv) Nature of obligation to work

It is expected from non-executive directors to attend board meetings and to obtain and maintain in depth knowledge of the business of the company (King, 2009:49). It is noted, however, that non-executive directors are not bound to attend all meetings, but should do so if possible (Edward Nathan Sonnenbergs Inc., 2010: 219). This is a strong indicator that it is the result of the non-executive director’s productive capacity being bought instead of the productive capacity itself.

This indicates “independent contractor” status in terms of Interpretation Note 17 (Issue 3).

v) Client base

It is permissible for a non-executive director to hold more than one directorship, provided that they will be able to exercise due care and diligence (King, 2009: 49; PwC, 2012:23). According to Seakamela (2011:56) is it common for non-executive directors, especially those of Johannesburg Securities Exchange listed companies, to hold a number of directorships in other companies.

This is a strong indicator that it is the result of the non-executive director’s productive capacity being bought instead of the productive capacity itself.

This indicates “independent contractor” status in terms of Interpretation Note 17 (Issue 3).

vi) Risk

A non-executive director whose performance is poor can be removed in terms of section 71(3)(b) of the Companies Act (71 of 2008). In addition, non-executive directors are also paid a fixed fee (King, 2009: 44; PwC 2012:36) and therefore bear the risk of time over-runs.

This indicates “independent contractor” status in terms of Interpretation Note 17 (Issue 3).

The analysis of persuasive indicators is as follows:

i) Extent of control

Non-executive directors determine their own work and sequence of work and are not bound by the orders of the company about what work they should do. This is necessary to ensure their independence (Van Schalkwyk & Nel, 2013:415).

This indicates “independent contractor” status in terms of Interpretation Note 17 (Issue 3).

ii) Productive time (work hours and work week)

Edward Nathan Sonnenbergs Inc. (2010:219) indicated that the duties of a non-executive director are of an intermittent nature. It can be said with certainty that non-executive directors are not bound by normal working hours or a work week.

This indicates “independent contractor” status in terms of Interpretation Note 17 (Issue 3).

3.4 CONCLUSION

In this chapter the International Monetary Fund’s principles regarding tax law design and the provisions as per the Income Tax Act, common law and the South African Revenue Services’ Interpretation notes were analysed to determine if PAYE can be withheld from the fees earned by non-executive directors. Interpretational challenges and uncertainties were also identified.

With the research conducted and documented in this chapter, it can be argued that in principle a non-executive director may be an independent contractor and that his or her fees will most probably not constitute remuneration due to the fact that strong evidence exists in favour of the opinion that the result of the non-executive director’s productive capacity is bought instead of the productive capacity itself (refer to 3.3.3.3).

Other factors, such as the inability of a non-executive director to delegate his/her duties, may, however, indicate otherwise (refer to 3.3.3.1).

The impact of the classification of a non-executive director either as employee or independent contractor on the non-executive director's liability to register and account for VAT is analysed in chapter 4.

The probability and possible effect of a non-executive director classified as an independent contractor (in terms of South African common law) but deemed as an employee (in terms of the first proviso to paragraph (ii) of the "remuneration" definition as per the Fourth Schedule to the Income Tax Act (58 of 1962)), are also considered in chapter 4.

CHAPTER 4

AN ANALYSIS OF THE ENTERPRISE DEFINITION AND THE INTERACTION THEREOF WITH THE REMUNERATION DEFINITION

4.1 INTRODUCTION

With the research conducted and documented in the previous chapter, it was noted that strong evidence exists in support of the argument that a non-executive director is an independent contractor and that his or her fees will most probably not constitute remuneration as long as the non-executive director is not subjected to the control or supervision of any person in the performance of his or her duties.

Based on the findings of chapter 3, the focus in this chapter is primarily to determine whether the services rendered by a non-executive director are subject to VAT or not. Firstly the requirements for the levying of and the registration for VAT in South Africa are identified. Thereafter an analysis of the “enterprise” definition was performed and the applicability thereof to the services being rendered by a non-executive director was considered. Lastly, the interaction between the “enterprise” and “remuneration” definitions, as per the VAT and Income Tax Act respectively, was considered. This was performed mainly to identify the probability and possible effect the difference in wording between the first proviso to paragraph (ii) of the “remuneration” definition and paragraph (iii)(bb) of the proviso to the “enterprise” definition may have on the typical non-executive director in South Africa.

This addresses the research objective as stated in 1.4.2, namely to analyse the definition of enterprise and to identify the interpretation challenges and uncertainties experienced with regards to the application thereof to a scenario where a non-executive director renders services, as required by King III, to the company he/she is a director of.

4.2 FUNDAMENTAL PRINCIPLES OF VALUE-ADDED TAX

VAT is a tax added to the cost of a product or service and is levied for purposes of generating revenue for the government. VAT is often referred to as a tax on consumption of goods or services, and is levied on the supply by a vendor of goods or services in the course or furtherance of any enterprise (Edward Nathan Sonnenbergs Inc., 2012; SARS, 2016b:1; Thuronyi, 1998a: 169).

The VAT-system must, in principle, be designed to bring within its charge every kind of economic transaction. For this reason "supply of services" is normally defined as any supply within the scope of VAT that is not a supply of goods or a supply of land. This ensures that almost all transactions in the economy will be potentially taxable (Thuronyi, 1998a: 188).

The non-executive director's advisory services to the board and management of the company (refer to 2.2.4) should in principle be a "supply of services." The services rendered may fall within the scope of VAT should the non-executive director be classified as an independent contractor by applying the statutory and common-law tests (refer to 3.3.3).

The non-executive director should therefore consider his or her statutory obligation to register as a VAT vendor. The requirements for VAT registration in South Africa are discussed in 4.3 below.

4.3 REGISTRATION REQUIREMENTS

Section 7(2) of the VAT Act (89 of 1991) determines that the vendor that is making the supply is responsible for the payment of VAT:

“Except as otherwise provided in this Act, the tax payable in terms of paragraph (a) of subsection (1) shall be paid by the vendor referred to in that paragraph, the tax payable in terms of paragraph (b) of that subsection shall be paid by the person referred to in that paragraph and the tax payable in terms of paragraph (c) of that subsection shall be paid by the recipient of the imported services.”

The “vendor” definition in Section 1(1) states specifically that vendors are not only registered persons, but includes any person that is required to be registered. It is therefore important to understand what the requirements for compulsory VAT registration in South Africa are.

4.3.1 Compulsory registration

Section 23(1) of the VAT Act (89 of 1991) states the following:

“Every person who, on or after the commencement date, carries on any enterprise and is not registered, becomes liable to be registered—

- (a) at the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R1 million;*
- (b) at the commencement of any month where the total value of the taxable supplies in terms of a contractual obligation in writing to be made by that person in the period of 12 months reckoned from the commencement of the said month will exceed the above-mentioned amount:*
 - (i) Provided that the total value of the taxable supplies of the vendor within the period of 12 months referred to in paragraph (a) or the period of 12 months referred to in paragraph (b) shall not be deemed to have exceeded or be likely to exceed the amount contemplated in paragraph (a), where the Commissioner is satisfied that the said total value will exceed or is likely to exceed such amount solely as a consequence of—any cessation of, or any substantial and permanent reduction in the size or scale of, any enterprise carried on by that person; or*
 - (ii) the replacement of any plant or other capital asset used in any enterprise carried on by that person; or*
 - (iii) abnormal circumstances of a temporary nature.”*

The person will be liable for compulsory VAT registration if he or she is carrying on an enterprise and make taxable supplies in the course or furtherance of that enterprise exceeding R1 million in any consecutive period of 12 months, or will exceed that amount in terms of a written contractual obligation. The R1 million compulsory VAT registration threshold applies to the total value of taxable supplies (turnover) and not the net income (profit) for the period (SARS, 2016b:9).

Based on the above-mentioned, the definition of “enterprise” is the first point one must consider to determine if a non-executive director has to be registered for VAT in South Africa (De Koker & Kruger, 2016b; Silver & Beneke, 2016) as output VAT cannot be levied if the service being rendered is not in the course or furtherance of an enterprise (section 7(1)(a)

of the VAT Act (89 of 1991)). The definition of “enterprise” and the applicability thereof to the services being rendered by a non-executive director are considered in 4.4 below.

4.4 DEFINITION OF ENTERPRISE

Section 1(1) of the VAT Act (89 of 1991) states that enterprise means:

“(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...”

The requirements in terms of paragraph (a) of the definition of “enterprise” are broken down and analysed as follows:

- i) Any enterprise or activity (refer to 4.4.1);
- ii) carried on continuously or regularly (refer to 4.4.2);
- iii) in the course or furtherance of which services are supplied to any other person (refer to 4.4.3); and
- iv) for a consideration (refer to 4.4.4).

4.4.1 Any enterprise or activity

The phrase “enterprise or activity” makes the definition of enterprise very wide, resulting in most activities constituting an enterprise (De Koker & Kruger, 2016a; SARS, 2013:10).

The use of the term “enterprise” as part of the definition of the same term means that the ordinary meaning of the word will apply (De Koker & Kruger, 2016a; SARS, 2013:10). The term “activity” is not defined in the VAT Act.

Therefore the ordinary meaning of “enterprise” and “activity” will be considered. The terms “activity” and “enterprise” are defined as follows according to the Business Dictionary (2016): “Enterprise’ means:

- i) A business or company.
- ii) entrepreneurial activity, especially when accompanied by initiative and resourcefulness.”

“Activity’ means:

- i) Measurable amount of work performed to convert inputs into outputs.”

The phrase “enterprise or activity” normally refers to commercial activities where goods or services are supplied for a consideration. These are carried out in an organised manner like a business. The goal is to expand the business or to ensure that the business is viable. An element of risk-taking must be involved and the aim must be to grow or make profit or to ensure that the organisation is sustainable (SARS, 2013:11; Smith v Anderson, 1880).

Profit is, however, only one of the elements involved. Any activity, even without making profit, with the intention of carrying it on as long as it is thought desirable, will constitute a business (Modderfontein Deep Levels Ltd v Feinstein, 1920).

Based on the duties and responsibilities of a non-executive director, as summarised in chapter 2, it is concluded that reasonable grounds exist to support the argument that the services rendered by non-executive directors will fall within the ambit of an “activity” as it will consume time and effort to analyse the business and to obtain a thorough understanding of the business (inputs) to be able to generate the required output, i.e.:

- i) The attendance of meetings;
- ii) to challenge the thinking of the board of directors (La Grange & Comminos, 2012);
- iii) to offer different perspectives and to challenge the board due to their past experience, together with their distance from the day-to-day running of the company (Roberts *et al.* 2005: 10); and
- iv) to constructively challenge management to ensure that long term objectives and strategies are met and achieved respectively (Seegers, 2008:28-29).

4.4.2 Carried on continuously or regularly

The term “carried on continuously or regularly,” similar to the term “activity,” is not defined in the VAT Act (Institute of Directors Southern Africa, 2016:17). Currently is there also no South African VAT authority on the interpretation thereof.

SARS's view, as set out in Interpretation note 70 (SARS, 2013:12), of the meaning of the phrase is as follows:

“The definition also contemplates that the business or enterprise activity is carried on all the time (continuously), or it must be carried on at reasonably short intervals (regularly). ‘Continuously’ is generally interpreted as ongoing, that is, the duration of the activity has neither ceased in a permanent sense, nor has it been interrupted in a substantial way. The term ‘regular’ refers to an activity that takes place repeatedly. Therefore, an activity can be ‘regular’ if it is 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.”

The above-mentioned interpretation of the phrase is in line with the principles laid down in New Zealand court cases, namely N27 (1991) 13 NZTC 3,299, *Wakelin v CIR* (1997) 18 NZTC 13,182(HC) and *Allen Yacht Charters Limited v CIR* ((1994a) (16 NZTC 11,270).

With regards to the services rendered by non-executive directors, there is a view in certain academic circles that the holding of one non-executive director position would not constitute a “continuously or regular” activity (Institute of Directors Southern Africa, 2016:12).

Based on the fact that it is expected (in terms of King III) from non-executive directors to attend board meetings and to obtain and maintain in-depth knowledge of the business of the company (King, 2009:49), the other view is that even with only one board position, the appointment as a non-executive director of a company will require steadiness of action which is repeated at fairly fixed times (Institute of Directors Southern Africa, 2016:12). This view was also supported in SAIT's submission to SARS (SAIT, 2016): “Non-executive directors may arguably fall within the ‘enterprise’ definition. These directors potentially can be viewed as engaged in an ‘activity’ that is carried on ‘regularly’ in furtherance of supplying services for consideration, and the activity is carried on in the form of a commercial, financial or professional concern.”

The view that the appointment as a non-executive director of a company will require steadiness of action which is repeated at fairly fixed times is also supported in a recent Australian judgement.

In Australian Securities and Investments Commission v Healey (2011) the court commented that:

“All directors must carefully read and understand financial statements before they form the opinions which are to be expressed. Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company’s financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director.

These include the following:

- A director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged;*
- a director should keep informed about the activities of the corporation;*
- whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies;*
- a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements;*
- a director, whilst not an auditor, should still have a questioning mind.”*

The court re-emphasised that the responsibility to pay appropriate attention to the business of the company, and to give any advice due consideration and exercise his or her own judgment in the light thereof is also applicable to non-executive directors (Deloitte, 2013: 6).

This case is relevant to directors of South African companies, because the new Companies Act, Section 5(2) indicates that a court, when interpreting or applying the provisions of the Act, may consider foreign company law (Deloitte, 2013: 6).

Based on the duties and responsibilities of a non-executive director, it is concluded that reasonable grounds exist to support the argument that the services rendered by non-executive directors may be regarded as a business or enterprise activity that is carried on continuously or regularly.

4.4.3 In the course or furtherance of which services are supplied to any other person

As VAT is a tax levied on the supply of goods or services by a vendor, it stands to reason that this phrase is the focus of attention in the definition of “enterprise.” It is the fundamental concept which underpins the VAT system as a whole, as there can be no “enterprise” if no goods or services are supplied (SARS, 2013:12).

The terms “supply”, “goods” and “services” are all defined very widely in section 1(1) of the VAT Act. This is to ensure that the tax base is as wide as possible so that almost all transactions in the economy (except those purposefully excluded) will be potentially taxable.

Section 1(1) of the VAT Act (89 of 1991) states that “service” means:

“Anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (c) of the definition of ‘goods.’”

From a South African perspective, especially in terms of King III, it is required from a non-executive director to render independent advisory services to the board of directors and management of the company. This includes, amongst other things, that he or she must be an active contributor by attending meetings and must also provide critical and meaningful input into matters affecting the company (Institute of Directors Southern Africa, 2011:6; PwC, 2012:8).

Based on the duties and responsibilities of a non-executive director, it is concluded that reasonable grounds exist to support the argument that the services rendered by non-executive directors may be regarded as a service supplied to another person in the course or furtherance of an enterprise.

4.4.4 For a consideration

Consideration is defined in Section 1(1) of the VAT Act (89 of 1991):

“‘consideration’, in relation to the supply of goods or services to any person, includes any payment made or to be made (including any deposit on any returnable container and tax), whether in money or otherwise, or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or by any other person, but does not

include any payment made by any person as a donation to any association not for gain: Provided that a deposit (other than a deposit on a returnable container), whether refundable or not, given in respect of a supply of goods or services shall not be considered as payment made for the supply unless and until the supplier applies the deposit as consideration for the supply or such deposit is forfeited.”

A typical non-executive director will receive director’s fees for meetings attended and for responsibilities undertaken, not a salary (Seegers, G. 2008, 28-29).

Based on the above-mentioned facts it is concluded that reasonable grounds exist to support the argument that the fee earned by non-executive directors may constitute “consideration” as defined in section 1(1) of the VAT Act.

4.5 THE IMPLICATIONS OF THE PROVISO TO THE “ENTERPRISE” DEFINITION AND THE INTERACTION THEREOF WITH THE FIRST PROVISO TO PARAGRAPH (ii) OF THE “REMUNERATION” DEFINITION

The fiscus’ intention with the abovementioned provisos to both the “enterprise” and the “remuneration” definitions was to ensure that a person will not be liable for VAT when such a person is an “employee” and in receipt of “remuneration” and *vice versa* (SARS, 2016b: 144). The rationale behind this rule is to choose the simplest and most effective tax rule (i.e. the least administrative burden option) should the transaction not generate any revenue for the state. From a VAT perspective a “business-to-business” supply is an example of a transaction that does not generate any revenue for the state (Ecker, 2012:108).

In layman’s terms a “business-to-business” supply is a transaction where the goods supplied or services rendered are used as an input in the value-adding chain and as a result the output VAT charged by the seller is cancelled out by the input VAT claim of the buyer.

It is submitted that employees’ services will most probably constitute “business-to-business” supplies should these services not be excluded from the “taxable activity” or “enterprise” definitions. This is based on the assumption that these services will be used as an input in the value-adding chain, and not for final consumption.

The fiscus’ intention mentioned above is also in line with the fundamental principles of PAYE and VAT. For VAT purposes employees’ services must be excluded in principle from the

“taxable activity” or “enterprise” definitions as a taxable person or vendor can only be an entity or person who independently carries out economic activities, regardless of the proposed results of those activities (Hart, 1994: 16-17; Thuronyi, 1998a: 190). The same also apply to employees’ tax.

According to the International Monetary Fund’s principles regarding tax law design the employment definition must be coordinated with the definition of business so that the same economic activity is not characterised as both a business and employment (Thuronyi, 1998b: 599).

Contrary to this intention is it currently theoretically possible for a non-executive director, who is an independent contractor in terms of the dominant impression test (refer to 3.3.3.3), to be liable for VAT even if employees’ tax were deducted from his or her fees.

This is due to the fact that an independent contractor is deemed to be an employee in receipt of “remuneration” if it is required that the services must be performed mainly at the premises of the person paying for the service and if the services to be performed are subject to the control and supervision of any other person (first proviso to paragraph (ii) of the “remuneration” definition), whilst the VAT Act does not have a similar exclusion in paragraph (iii)(*bb*) of the proviso to the “enterprise” definition (Kruger, 2015:11).

It is, however, highly unlikely for a non-executive director to be classified as an employee in terms of the “premises” test as it is not normally required from non-executive directors to perform their services mainly at the premises of the company (refer to 3.3.3.2). The same applies to the “control and supervision” test, as it is normally required from non-executive directors to be independent from the companies they are directors of (refer to 2.2.3 and 3.3.3.2).

It can therefore be concluded that the identified exception caused by the difference in wording of the “enterprise” and “remuneration” definitions will in practice only occur in exceptional circumstances.

4.6 CONCLUSION

The principles of VAT and PAYE were considered and it was noted that when PAYE is withheld from an amount received, the activity that generated that income should in principle not be subjected to VAT and *vice versa*.

It was further concluded that reasonable grounds exist to support the argument that a non-executive director may fall within the “enterprise” definition. This will specifically be applicable to the non-executive director who is classified as an independent contractor in terms of the statutory and/or common law tests (refer to chapter 3). In such a scenario is it likely that the non-executive director will be liable to register as a VAT vendor as and when it is certain that his or her fees will exceed R 1 million in a twelve-month period.

During the research certain unexpected scenarios were identified. It is currently theoretically possible for a non-executive director, who is an independent contractor in terms of the dominant impression test (refer to 3.3.3.3), to be liable for VAT even if employees’ tax has been deducted from his or her fees due to the difference in the wording of paragraph (iii)(*bb*) of the proviso to the “enterprise” definition and the first proviso to paragraph (ii) of the “remuneration” definition as per the Value-Added Tax Act and Income Tax Act respectively. It is, however, submitted that such a scenario would be rare in practice (refer to 4.5 above).

In the next chapter the focus is primarily to establish whether the conclusions reached in this study are in line with New Zealand’s interpretation notes, legislation and case law. New Zealand is considered to be a suitable country for the comparison, as the New Zealand GST Act and commentary are often referenced when interpretation or case law regarding a specific VAT matter is absent in South African commentary or case law.

CHAPTER 5

DIRECTORS' FEES AND GOODS AND SERVICES TAX (GST) IN NEW ZEALAND

5.1 INTRODUCTION

As the South African VAT Act is essentially an espousal of the New Zealand GST Act, the New Zealand GST Act and commentary are often referenced when interpretation or case law regarding a specific VAT matter is absent in South African commentary or case law (Bardopoulos, 2015: 205).

South African principles and provisions are, as a result, fairly similar to those of New Zealand (Bardopoulos, 2015: 205). There are some dissimilarities, such as the specific exclusion of director's services from the "taxable activity" definition (the equivalent of the South African term "enterprise" (Maples, 2000:442)) in section 6(3)(b) of the Goods and Services Tax Act (141 of 1985).

The purpose of this chapter is to formulate conclusions and to make recommendations (with New Zealand's interpretation notes, legislation and case law as a guideline) regarding the uncertainties identified in chapter 3 and 4. This addresses the research objective (iv) as stated in 1.4.2.

5.2 BASIC GST AND EMPLOYEES' TAX PRINCIPLES IN NEW ZEALAND

It can be argued that New Zealand's tax laws, in comparison with South African tax laws, share the same basic principles regarding the withholding of employees' tax and the levying of GST/VAT with the supply of goods or services, with some exceptions.

Firstly, as in South Africa, an evaluation must be performed to determine whether a person is an employee or independent contractor.

The classification as an employee will require the employer to deduct PAYE and the activities performed are not subjected to GST due to the specific exclusion in section 6(3)(b) of the GST Act (Inland Revenue, 1996:2; Inland Revenue, 2014a & Rudman 2013: 35).

The classification as an independent contractor, on the other hand, will require the independent contractor to register for GST if certain prerequisites are met, whilst the user or acquirer of the service does not need to withhold any taxes as long as the duties performed by the independent contractor are not listed in schedule 4, part B to the Income Tax Act (97 of 2007) (CCH New Zealand, 2013:141; Inland Revenue, 2013:1 & Inland Revenue, 2014a). The user of the service has to be registered as an employer and is required to withhold tax on schedular payments if the services rendered are listed in the above-mentioned schedule (CCH New Zealand, 2013:141; Inland Revenue, 2013:1 & Inland Revenue, 2014a).

Directors' fees are listed in schedule 4, part B and companies are therefore liable to withhold tax on schedular payments at a rate of 33% on the director's fees payable (CCH New Zealand, 2013:141).

The classification of the non-executive director, as per New Zealand law, is evaluated in 5.3 below.

5.3 CLASSIFICATION OF THE NON-EXECUTIVE DIRECTOR IN TERMS OF NEW ZEALAND LAW

When asked to determine the employment status of an individual, the courts often refer to three common law tests designed to assess the way the relationship operates in practice (EY, 2016:19; Rudman, 2013: 33):

- i) Control test. This test focuses primarily on the hiring entity's ability to exert significant control over the individual's work. The higher the degree of control, the more likely the individual is to be a contractor (Rudman, 2013: 33; EY, 2016:19).
- ii) Integration test. This test focuses on whether the individual's services form an integral part of the hiring entity's business. The greater the degree of integration, the more likely the individual is to be an employee (Rudman, 2013: 33; EY, 2016:19).
- iii) Fundamental test. This test primarily focuses on the individual's activities and if they reflect a business of his or her own account. The following factors are considered: Does the person hold insurance, serve multiple clients, advertise services, provide their own equipment; hire employees? If so, these are factors in favour of a contractor (Rudman, 2013: 33; EY, 2016:19).

It can be argued that tests i) to iii) are in principle the same as the South African “dominant impression” test (refer to 3.3.3.3).

It is therefore submitted that strong evidence exists that may support the view that a non-executive director is an independent contractor in terms of New Zealand law.

The impact thereof on the non-executive director’s obligation to register and account for GST is analysed in 5.4 below.

5.4 DIRECTORS’ FEES AND GOODS AND SERVICES TAX (GST)

In an effort to eliminate confusion the New Zealand’s Inland Revenue Department published an updated binding public ruling, BR Pub 15/10, in 2015. This Ruling and Commentary explains whether directors’ fees are subject to GST. The Ruling and Commentary also consider whether a company engaging a director is entitled to claim input tax deductions for fees paid to that director (Inland Revenue, 2015: 5).

The binding public ruling, BR Pub 15/10, sets out that a director must charge GST on the supply of their services when the following requirements are satisfied:

- i) The director is registered or liable to be registered in respect of a taxable activity (New Zealand’s alternative to the South African term “enterprise” (Maples, 2000:442)) that they undertake, and
- ii) the director accepts the office in carrying on that taxable activity (Inland Revenue, 2015: 5).

The requirements in terms of the binding public ruling are broken down and analysed as follows:

- i) Compulsory registration threshold in New Zealand to be liable to be registered (refer to 5.4.1);
- ii) the requirements to classify as a “taxable activity” (refer to 5.4.2):
 - An activity (refer to 5.4.2.1);
 - carried on continuously or regularly (refer to 5.4.2.2);
 - the activity involves the supply of goods and services to another person for consideration (refer to 5.4.2.3)
- iii) the meaning of “accepting the office in carrying on that taxable activity” (refer to 5.4.3).

The applicability of the public ruling on non-executive directors was analysed since the document only refers to “directors” (refer to 5.4.4).

5.4.1 Compulsory registration threshold in New Zealand to be liable and to account for Goods and Services Tax

A person is liable to register for GST in New Zealand if the person supplies goods or services in the course of carrying on a taxable activity and the total value of the supplies exceeded \$60 000 in a 12-month period (Section 51 of the New Zealand GST Act (141 of 1985)).

GST is levied on the supply of goods and services (except for exempt supplies) made in New Zealand “by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply” (Section 8(1) of the New Zealand GST Act (141 of 1985)).

5.4.2 The requirements to classify as a “taxable activity”

The meaning of the term “taxable activity,” in terms of section 6 of the GST Act (141 of 1985), is as follows:

- “(1) For the purposes of this Act, the term taxable activity means—*
- (a) any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:*
 - (b) without limiting the generality of paragraph (a), the activities of any public authority or any local authority.*
- (2) Anything done in connection with the beginning or ending, including a premature ending, of a taxable activity is treated as being carried out in the course or furtherance of the taxable activity.*
- (3) Notwithstanding anything in subsections (1) and (2), for the purposes of this Act the term taxable activity shall not include, in relation to any person,—*
- (a) being a natural person, any activity carried on essentially as a private recreational pursuit or hobby; or*

- (aa) *not being a natural person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby; or*
 - (b) *any engagement, occupation, or employment under any contract of service or as a director of a company, subject to subsection (4); or:*
 - (c) *any engagement, occupation, or employment—*
 - (i) *pursuant to the Members of Parliament (Remuneration and Services) Act 2013 or the Governor-General Act 2010;*
 - (ii) *as a Judge, Solicitor-General, Controller and Auditor-General, or Ombudsman;*
 - (ia) *pursuant to an appointment made by the Governor-General or the Governor-General in Council and evidenced by a warrant or by an Order in Council or by a notice published in the Gazette in accordance with section 2(2) of the Official Appointments and Documents Act 1919;*
 - (iii) *as a Chairman or member of any local authority or any statutory board, council, committee, or other body, subject to subsection (4); or*
 - (d) *any activity to the extent to which the activity involves the making of exempt supplies.*
- (4) *Despite subsection (3)(b) and (c)(iii), if a director, member, or other person referred to in those paragraphs is paid a fee or another amount in relation to their engagement, occupation, or employment in circumstances in which they are required to account for the payment to their employer, the payment is treated as consideration for a supply of services by the employer to the person who made the payment to the director, member, or other person.*
- (5) *For the purposes of subsections (3)(b), (c)(iii), and (4), if a person in carrying on a taxable activity, accepts an office, any services supplied by that person as holder of that office are deemed to be supplied in the course or furtherance of that taxable activity.”*

The requirements to classify as a “taxable activity” are discussed below.

5.4.2.1 There must be some form of “activity”

The Newman v CIR (1994b) case defined the meaning of the term activity as follows:

“[Activity] is a word of considerable breadth. The New Shorter Oxford English Dictionary 1993 ascribes a number of varying meanings or shades of meaning, none of which is exactly apposite to the word in its context in s 6. The nearest, I think is ‘an occupation, a pursuit’ and (in the plural) ‘things that a person, animal or group chooses to do.’ In its context here I think the word means a course of conduct or series of acts which a person has chosen to undertake or become engaged in.”

It can be argued that the test to determine if a non-executive director’s roles and responsibilities will constitute an “activity” will exactly be the same as in South Africa. Refer to 4.4.1.

5.4.2.2 “Carried on continuously or regularly”

The N27 (1991), Wakelin v CIR (1997) and Allen Yacht Charters Limited v CIR (1994a) court cases defined the meaning of the above-mentioned phrase as a business or enterprise activity that is carried on all the time (continuously), or it must be carried on at reasonably short intervals (regularly).

“Continuously” is generally interpreted as ongoing, that is, the duration of the activity has neither ceased in a permanent sense, nor has it been interrupted in a substantial way. The term “regular” refers to an activity that takes place repeatedly. Therefore, an activity can be “regular” if it is 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. This is also the current view of the New Zealand’s Inland Revenue Department (Inland Revenue, 1995: 9).

It can be argued that the test to determine if a non-executive director’s roles and responsibilities will constitute an “activity which is carried on continuously or regularly” will exactly be the same as in South Africa. Refer to 4.4.2.

5.4.2.3 The activity involves the supply of goods and services to another person for a consideration

As stated in the IRD Tax Information Bulletin: Volume Seven No.3, the main component of a taxable activity is the supply of goods or services for a consideration (Inland Revenue, 1995: 9).

Services means anything which is not goods or money (Section 2 of the New Zealand GST Act (141 of 1985)), whilst consideration means any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person; but does not include any payment made by any person as an unconditional gift to any non-profit body (Section 2 of the New Zealand GST Act (141 of 1985)).

It can be argued that the test to determine if a non-executive director's services will constitute "the supply of services for a consideration" will exactly be the same as in South Africa. Refer to 4.4.3 and 4.4.4.

5.4.3 Accepting the office in carrying on that taxable activity

Section 6(3) provides certain exclusions from the term "taxable activity." Any engagement, occupation or employment of a person as a director is excluded from the definition of "taxable activity" (Section 6(3)(b) of the GST Act (141 of 1985)). This rule is designed to keep directors out of the GST net, unless their activities as a director are performed as part of a broader taxable activity, in which case their directorship will form part of that activity (Mc Kenzie, 2008:1301).

In plain English the above-mentioned exception to the rule will only apply if a person accepts a director's position in the course or furtherance of an already existing business activity, for example an accounting practice or law firm (CCH New Zealand, 2013:1381; Inland Revenue 2014: 96; Inland Revenue, 2015: 8). It is submitted that it is highly probable that a chartered accountant or lawyer in practice may take up a non-executive director's position as part of or in the furtherance of his or her existing practice. The exclusion, as stated in section 6(3)(b) of the Goods and Services Tax Act (141 of 1985), will then not be applicable.

The binding public ruling, BR Pub 15/10, gives the following two examples in explaining the proviso to the exclusion of director's services from the definition of "taxable activity" (Inland Revenue, 2015: 9):

Example 1:

Claudius, who is not registered for GST, is an employee of a marketing agency. Fortinbras Ltd engages Claudius as a director and pays him fees for his services. Claudius' appointment as a director is not connected with his employment, nor has he accepted the directorship as part of carrying on a taxable activity. He retains the fees, having received them in his personal capacity.

Claudius is engaged as a director of a company, an activity that is excluded from the term "taxable activity" by S 6(3)(b). Section 6(5) does not apply, because Claudius did not accept the directorship as part of carrying on a taxable activity. Claudius is not required to account for GST on the fees received for directorship services.

Fortinbras Ltd cannot claim input tax deductions on the fees paid to Claudius because no GST was charged on those fees.

Example 2:

Ophelia is a human resources consultant in business on her own. She is registered for GST. Ophelia accepts a position as a director of Reynaldo Ltd as part of carrying on her taxable activity. She receives fees for her services.

Because Ophelia has accepted the directorship as part of carrying on her taxable activity, S 6(5) deems her services to be supplied in the course or furtherance of her taxable activity. Ophelia should therefore provide Reynaldo Ltd with a tax invoice and account for GST output tax on the fees she is paid.

Reynaldo Ltd may claim input tax deductions for the fees paid to Ophelia, provided the requirements of the Act, such as S 20(2), are met." (My emphasis).

It is clear that a non-executive director who accepted a directorship to provide independent input in order to challenge the board of directors (La Grange & Comminos, 2012:20-21) and management (Seegers, 2008:28-29) in the course or furtherance of a pre-existing taxable activity (i.e. enterprise) for a consideration will activate section 6(5) of the GST Act. The non-executive director will then be liable to register and account for GST.

5.4.4 The applicability of the Public Ruling, BR PUB 15/10, on non-executive directors

Two amendments have been made to section 6 that relate to the GST treatment of fees paid to directors and board members (Inland Revenue, 2014b: 96).

The first amendment provides that when an employee is engaged by an entity to be a director of another company, and the employee is required to remit fees to their employer for any payments received, the employer will be treated as supplying services to the third party. The employer will therefore return GST and the third party will be able to claim input tax on the payment for these services (Inland Revenue, 2014b: 96). This amendment was made to ensure the neutrality of the GST system. Before the amendment the company who paid the fees did not receive an input tax deduction as it relates to employment. However, when the employee passes these fees on to his employer, the employer is required to account for output tax on the payment as it is a payment received in the course and furtherance of their taxable activity (Inland Revenue, 2014b: 96).

The second amendment extends the proviso under section 6(3)(b), that deems services performed by directors to be supplied in the course and furtherance of a taxable activity when that director has a broader taxable activity, to persons listed in section 6(3)(c)(iii), such as members of boards (Inland Revenue 2014b: 96).

But this change was not covered in the revised ruling (BR Pub 15/10). It is, however, as mentioned above, discussed in a Tax Information Bulletin (Vol 26 no7, August 2014) which says that the change is intended to subject directors and members of boards to the same rules (New Zealand Institute of Directors, 2015: 2).

It can therefore be concluded that a non-executive director, if different from a “director” for GST purposes, will at least be a board member and hence will public ruling, BR Pub 15/10, be applicable to non-executive directors.

5.5 DIRECTORS’ FEES AND TAX ON SCHEDULAR PAYMENTS

It is submitted that tax on schedular payments are in effect the same as South African provisional tax. It is, like provisional tax, a manner to collect the normal income tax due on independent contractors’ fees (Inland Revenue, 2007).

The only differences between tax on schedular payments and provisional tax are the timing (as and when a payment is made *versus* bi-annually on fixed dates respectively), the method of determining the amount payable (fixed rate *versus* a progressive sliding scale respectively) and the person or entity responsible for the withholding and payment of tax (the user of the service *versus* the taxpayer).

As stated in 5.3 above, strong evidence exists that may support the view that a non-executive director is an independent contractor in terms of New Zealand law. The company must therefore withhold tax on schedular payments at a rate of 33% from the GST-exclusive amount if the non-executive director is classified as an independent contractor and the company holds a tax invoice issued by the payee (CCH New Zealand, 2013:141). If such a tax invoice is not held, the company must, in terms of the Income Tax (Withholding Payments) Regulations 1979, withhold tax on schedular payments from the gross amount of the payment inclusive of any GST charged by the payee (CCH New Zealand, 2013:141).

In terms of section RD 8(3) of the Income Tax Act (97 of 2008) the expenditure incurred in deriving a schedular payment is allowed as a deduction in determining the withholding tax payable (CCH New Zealand, 2013:141). The Commissioner may however determine what amount or proportion of any schedular payment shall be regarded as expenditure incurred in the derivation of such payment (CCH New Zealand, 2013:186).

The non-executive director, if classified as an independent contractor, will be able to deduct business expenses in determining his or her taxable income (Inland Revenue, 2011:3-6). In terms of Interpretation Guideline: IG11/01, paragraph 11 read together with paragraph 19, the withholding of tax on schedular payments will not have an impact on the deductibility of business expenses incurred by the independent contractor (Inland Revenue, 2011:3-6).

5.6 DIRECTORS' FEES AND EMPLOYEES' TAX

The company must withhold employees' tax on the fees payable to the non-executive director if the non-executive director is classified as an employee in terms of the common law tests (refer to 5.3 above) (CCH New Zealand, 2013:141; Rudman 2013: 35). The non-executive director, if classified as an employee, will not in terms of section DA 2(4) of the Income Tax Act be able to deduct employment-related expenses in determining taxable income (Rudman, 2013:35).

South Africa has similar statutory limitations with regards to the deductibility of employment-related expenses. Section 23(m) of the Income Tax Act (58 of 1962) prohibits the deduction of any expenditure, loss or allowance which relates to any employment of or office held by any person (other than an agent or representative whose remuneration is normally derived mainly in the form of commissions based on his or her sales or the turnover attributable to him or her) in respect of which he or she derives any remuneration (Stiglingh *et al.*, 2015:161).

5.7 CONCLUSION

This study has evaluated the way problems regarding interpretation and uncertainties that have been identified in chapter 3 and 4 are dealt with in New Zealand:

Interpretation problem and uncertainty	South Africa	New Zealand
Classification of the non-executive director, based on the roles and responsibilities as set out in chapter 2.	Strong evidence exists that may support the view that a non-executive director is an independent contractor in terms of South African law.	Strong evidence exists that may support the view that a non-executive director is an independent contractor in terms of New Zealand law.
Tax consequences if classified as an independent contractor (in terms of both the statutory and common law tests)	<p><i>Employees' tax</i> - No obligation on company to deduct PAYE on amounts paid to non-executive directors.</p> <p><i>Income tax</i> - Section 23(m) of the Income Tax Act will not be applicable. Business-related expenses are deductible.</p> <p>The non-executive director must register as a provisional tax payer.</p>	<p><i>Employees' tax</i> - No obligation on the company to deduct PAYE on amounts paid to non-executive directors.</p> <p><i>Income tax</i> – Business-related expenses are deductible.</p> <p>The company has an obligation to deduct tax on schedular payments at a flat rate of 33%.</p>

Interpretation problem and uncertainty	South Africa	New Zealand
<p>Tax consequences if classified as an independent contractor (in terms of both the statutory and common law tests) (Continued).</p>	<p><i>VAT</i> - The non-executive director must register and account for VAT if the fees on an annual basis exceed R1million.</p>	<p><i>GST</i> – The non-executive director does not have to be registered for GST, <i>unless</i> his or her activities as a director are performed as part of a broader taxable activity. The directorship will then form part of that pre-existing activity. The compulsory registration requirements must also be met (taxable supplies exceed \$60 000 on an annual basis.)</p>
<p>Tax consequences if classified as an independent contractor in terms of common law tests, but as an employee in terms of statutory tests</p>	<p><i>Employees’ tax</i> - Obligation on employer to deduct PAYE due to the inclusion of fees as remuneration (first proviso to paragraph (ii) of the “remuneration” definition.)</p> <p><i>Income tax</i> - Section 23(m) of the Income Tax Act will be applicable. Business-related expenses are not deductible.</p> <p><i>VAT</i> – The non-executive director must register and account for VAT if the fees on an annual basis exceed R1million. This exception is caused by the difference in the VAT Act’s wording of paragraph (iii)(bb) of the proviso to the “enterprise” definition, compared to the wording of the first proviso to paragraph (ii) of the “remuneration” definition.</p>	<p>It is submitted that such a scenario cannot exist in New Zealand.</p> <p>This is due to the specific exclusion of directors’ services from the “taxable activity” definition.</p>

Interpretation problem and uncertainty	South Africa	New Zealand
Tax consequences if classified as an employee in terms of both the statutory and common law tests	<p><i>Employees' tax</i> - Obligation on company to deduct PAYE on amounts paid to non-executive directors.</p> <p><i>Income tax</i> - Section 23(m) of the Income Tax Act will be applicable. Employment-related expenses are not deductible.</p> <p><i>VAT</i> – No obligation on the non-executive director to register as a VAT vendor.</p>	<p><i>Employees' tax</i> - Obligation on company to deduct PAYE on amounts paid to non-executive directors.</p> <p><i>Income tax</i> - Section DA 2(4) of the Income Tax Act will be applicable. Employment-related expenses are not deductible.</p> <p><i>GST</i> - No obligation on the non-executive director to register as a GST vendor.</p>

Based on the comparison above it can be argued that the outcomes in both countries are very similar. The means to achieve the outcome are however different.

The first similar outcome is that no tax revenues are generated from a VAT perspective. This is achieved in New Zealand by specifically excluding directors' services from the "taxable activity/enterprise" definition (refer to 5.4.3) whilst in South Africa it is achieved via a "business-to-business" supply. It is submitted that the New Zealand option is a more superior and effective tax rule (i.e. the least administrative burden option) whilst achieving a similar outcome.

Secondly a similar outcome is achieved in both countries where a non-executive director is classified as an independent contractor. Employees' tax is not deducted from the fees earned and expenses incurred in the production of those fees will be deductible.

Lastly was it noted that New Zealand opted for a more regular method to collect the taxes due. This was achieved by introducing a withholding tax regime on directors' fees. It is submitted that the New Zealand method will be more beneficial for the state by accelerating the collection of taxes, but the downside is the fixed rate used in determining the tax to be collected. This will most certainly lead to either an over or under recovery at the end of the fiscal year.

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 INTRODUCTION

The main objective of this study was to determine whether there may in principle be VAT and employees' tax consequences on the fees earned by non-executive directors and to suggest practical solutions for the identified uncertainties. Secondary objectives were identified to sufficiently address the main objective.

Chapter 2 identified and explored what exactly a non-executive director is by definition and what distinguishes a non-executive director from an executive director. This evaluation formed the cornerstone for the proper classification of the non-executive director as an employee or independent contractor and consequently to determine if the non-executive director's services constitute an "enterprise" for South African VAT purposes.

In chapter 3 the requirements to be classified either as an independent contractor or employee were evaluated. This evaluation was necessary to establish whether the fees paid to non-executive directors may in principle constitute "remuneration" as defined in the Fourth Schedule to the Income Tax Act (58 of 1961). The result of the above evaluation has a significant impact on the non-executive director's obligation to register and account for VAT due to the interaction between the "enterprise" definition and the first proviso to paragraph (ii) of the "remuneration" definition.

Based on the findings of chapter 3, chapter 4 focused primarily on the analysis of the "enterprise" definition and the identification of interpretation challenges and uncertainties experienced with the application thereof to non-executive directors' roles and responsibilities, as required by King III.

Chapter 5 identified how the interpretation uncertainties, identified in chapter 3 and 4, are dealt with in New Zealand. The purpose thereof was to formulate conclusions and to make recommendations (with New Zealand's interpretation notes, legislation and case law as a guideline) regarding the uncertainties identified in chapters 3 and 4.

Chapter 6 provides a summary of the results of the research conducted and concludes if the research objectives have been met in order to address the research question. It also contains recommendations with respect to the research question.

6.2 ACHIEVEMENT OF RESEARCH OBJECTIVES AND CONCLUSIONS REACHED

Each of the research objectives has been addressed and the conclusions reached are discussed below:

6.2.1 To identify and analyse the roles and responsibilities of non-executive directors to determine what sets them apart from executive directors

The objective was achieved by establishing the exact meaning of the term “non-executive director” and to conclude on the expected roles and responsibilities of a non-executive director in terms of King III and South African law.

Information provided in chapter 2 confirmed the definition of a non-executive director and their expected roles and responsibilities in terms of King III, the Companies Act (71 of 2008) and South African common law.

The evidence gathered confirmed that the characteristics, roles and responsibilities of non-executive directors set them apart from executive directors.

The first distinguishing factor is the requirement that non-executive directors must be independent from the companies they are directors of. Independence is accomplished by:

- i) Not being employed, present or past, by the company he or she is a director of;
- ii) not having any business relations with the above-mentioned company,
- iii) not to have any family connections with employees that may have an influence on the non-executive director; and
- iv) not to be significantly dependent on the fees earned from the company he or she is a director of.

The second distinguishing factor that sets the non-executive director apart is the latter's role to act as an independent advisor of the board and management. It is required from the non-executive director to:

- i) Be an active participant and contributor at meetings;
- ii) to provide critical and meaningful input;
- iii) to challenge the board's thinking and decision-making process; and
- iv) to challenge management regarding the achievement of long-term objectives and strategies.

6.2.2 To identify and explore the requirements to be classified either as an independent contractor or employee

The objective was achieved by establishing the exact meaning of the terms "independent contractor" and "remuneration" and lastly, based on the findings of chapter 2, to conclude whether a non-executive director is either an "employee" or "independent contractor" after considering the statutory and common law tests.

Information provided in chapter 3 indicated that *locatio conductio operarum* is essentially a relationship where the employee will only make available his or her productive capacity. *Locatio conductio operis*, on the other hand, is in essence a contract to acquire the results of productive capacity, i.e. the hire of completed work.

After considering the statutory and common law tests in the sequence as prescribed in Interpretation Note 17 (Issue 3), it is submitted that non-executive directors who perform the duties as prescribed by King III are rewarded for the result of their productive capacity, which is a strong indicator that non-executive directors could be classified as independent contractors for employees' tax purposes.

6.2.3 To analyse the definition of enterprise and to identify the interpretation challenges and uncertainties experienced with regards to the application thereof

The objective was achieved by applying the general tests and provisos, as contained in the "enterprise" definition, to the services rendered by non-executive directors.

In respect of the general definition of enterprise, as defined in Section 1(1) of the VAT Act, the information provided in chapter 4 disclosed the following:

The phrase “any enterprise or activity” widens the definition of enterprise, resulting in most activities constituting an enterprise. Is it submitted, based on the duties and responsibilities of a non-executive director summarised in chapter 2, that the services rendered by non-executive directors may fall within the ambit of an “activity.”

Furthermore is it required that the activity or enterprise must be “carried on continuously or regularly.” The term “carried on continuously or regularly,” similar to the term “activity,” is not defined in the VAT Act. Currently there is also no South African VAT authority on the interpretation thereof. It is submitted (based on the guidance set out in Interpretation Note 70 (2013) and the roles and responsibilities of non-executive directors summarised in chapter 2) that even with only one board position, the appointment as a non-executive director of a company may require steadiness of action which is repeated at fairly fixed times. It can therefore be argued that the non-executive director’s activities could classify as “carried on continuously or regularly.”

Lastly, must the rendering of the service be in the course or furtherance of the enterprise and for a consideration. Information provided in chapter 4 supports the view that the services rendered by non-executive directors may be regarded as a service supplied to another person in the course or furtherance of an enterprise and that the fees earned in the process constitute consideration.

In respect of the provisos to the definition of enterprise and the interaction thereof with the first proviso to paragraph (ii) of the “remuneration” definition:

The fiscus’ intention with the above-mentioned provisos to both the “enterprise” and the “remuneration” definitions was to ensure that a person will not be liable for VAT when such a person is an “employee” and in receipt of “remuneration” and *vice versa*.

Information provided in chapter 4 indicated the existence of unexpected deviations on the above-mentioned intention. It is currently theoretically possible for a non-executive director, who is an independent contractor in terms of the dominant impression test, to be liable for VAT even if employees’ tax were deducted from his or her fees due to the difference in the wording of paragraph (iii)(*bb*) of the proviso to the “enterprise” definition and the first proviso to paragraph (ii) of the “remuneration” definition as per the Value-Added Tax Act and Income Tax Act respectively. It is, however, submitted that such a scenario would be rare in practice.

Information supplied in chapter 4 suggested that reasonable grounds exist to support the argument that non-executive directors' services could fall within the ambit of the "enterprise" definition. This will specifically be applicable to the non-executive director who is classified as an independent contractor in terms of the statutory and/or common law tests (refer to chapter 3). In such a scenario is it likely that the non-executive director will be liable to register as a VAT vendor as and when it is certain that his or her fees will exceed R1 million in a twelve-month period.

6.2.5 To analyse the employees' tax consequences on the fees earned by non-executive directors and the latter's responsibility to register and account for Goods and Services Tax in New Zealand

The objective was achieved by comparing the employees' tax and GST consequences in New Zealand with the South African employees' tax and VAT consequences on the fees earned by non-executive directors.

Based on the comparison, it can be argued that the VAT/GST and employees' tax consequences of both countries on non-executive directors' fees are very similar. The means to achieve the outcome are, however, different.

The first similar outcome is that no tax revenues are generated from a VAT perspective. This is achieved in New Zealand by specifically excluding directors' services from the "taxable activity/enterprise" definition (refer to 5.4.3), whilst in South Africa it is achieved via a "business-to-business" supply. It is submitted that the New Zealand option is a more superior and effective tax rule (i.e. the least administrative burden option) whilst achieving a similar outcome.

Secondly, a similar outcome is achieved in both countries where a non-executive director is classified as an independent contractor. Employees' tax is not deducted from the fees earned and expenses incurred in the production of those fees will be deductible.

Lastly was it noted that New Zealand opted for a more regular method to collect the taxes due. This was achieved by introducing a withholding tax regime on directors' fees. It is submitted that the New Zealand method will be more beneficial for the state by accelerating the collection of taxes, but the downside is the fixed rate used in determining the tax to be

collected. This will most certainly lead to either an over or under recovery at the end of the fiscal year.

6.3 CONCLUSION AND RECOMMENDATIONS

Based on the research performed and after considering all the statutory and common law tests (refer to chapter 3), it can be concluded that strong evidence exists to support the argument that a non-executive director will most probably be classified as an independent contractor.

It can be argued, based on the above-mentioned classification, that the non-executive director may not be regarded as an employee for employees' tax purposes and that he or she may be required to register and account for VAT should the value of the fees earned exceed the registration threshold of R1 million.

This argument is also in line with the basic and fundamental principles of employees' tax and VAT (refer to chapter 3 and 4 respectively).

The following matters of concern were however noted:

- i) The current wording of the "enterprise" and "remuneration" definitions, as per the VAT Act and Income Tax Act respectively, creates a possible situation where a non-executive director will be liable for VAT, even if employees' tax was deducted from his or her fees. This is in contradiction with the fiscus' intention and the fundamental principles of PAYE and VAT.
- ii) The application of the law, as it currently stands, will most likely lead to an increase in the administrative burden of both SARS and the taxpayer without generating any additional tax revenues for the state from a VAT perspective. It is attributable to the fact that the independent advisory services of a non-executive director will most probably constitute a "business-to-business" supply.

Based on the research performed, the recommendations to SARS and National Treasury are as follows:

- i) It is recommended that SARS must either update Interpretation Note 17 or consider issuing additional guidance regarding the classification of non-executive directors as either employees or independent contractors.

- ii) It is suggested that SARS must consider issuing guidance, similar to New Zealand's BR Pub 15/10, to eliminate confusion regarding the non-executive director's responsibility to register and account for VAT.
- iii) Alternatively must section 1(1) of the VAT Act be amended to exclude any engagement, occupation, or employment as a director from the "enterprise" definition. This will result in the exact same net effect, but without the extra administrative burden (to both SARS and the non-executive director). This will also eliminate the arguably unintentional tax implications the difference in the wording between the first proviso to paragraph (ii) of the "remuneration" definition and paragraph (iii)(bb) of the proviso to the "enterprise" definition may have caused.
- iv) The next proposed amendment to the "enterprise" definition is to adopt the wording of section 6(4) of the New Zealand GST Act (refer to 5.4.2) should National Treasury implement the proposed amendment stated in iii) above. This will ensure the neutrality of the VAT system, should a director render his or her advisory services through a third-party intermediary.
- v) The last proposal is for National Treasury to implement a more regular method or mechanism to collect the income tax due. It is, however, not recommended that a new type of withholding tax, similar to New Zealand's "tax on schedular payments," should be implemented.

The most practical solution is to consider current mechanisms available (i.e. PAYE). It is suggested that the "remuneration" definition, as per paragraph 1 of the Fourth Schedule to the Income Tax Act, should be amended to specifically include directors' fees, even if the director is classified as an independent contractor. This will ensure the timely collection of taxes.

From a non-executive director's point of view, it is submitted that this proposed amendment will not have any negative tax consequences. It is not anticipated that such persons will incur material business-related expenses which might be denied in terms of section 23(m) of the Income Tax Act, should National Treasury implement the proposed amendment. This is due to the fact that the biggest component of the independent advisory services rendered by non-executive directors is actually their own time spent. There is in any case no tax deduction available for a person's own time spent in the production of their income.

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