

NON-EXECUTIVE DIRECTORS: EMPLOYEES OR INDEPENDENT CONTRACTORS FOR BOTH INCOME TAX AND EMPLOYEES' TAX PURPOSES?

Linda van Schalkwyk*

Stellenbosch University

lvschalk@sun.ac.za

Rudie Nel+

Stellenbosch University

rnel@sun.ac.za

Received: June 2012

Accepted: March 2013

Abstract

The concept 'independent contractor' is one of the more contentious concepts contained in the Fourth Schedule to the Income Tax Act 58 of 1962, as amended. The classification of a person rendering services as either an 'employee' or an 'independent contractor' is relevant for both income tax and employees' tax purposes. The objective of this article is to determine whether non-executive directors (both resident and non-resident) are employees or independent contractors for both purposes, respectively. A comprehensive literature review was done in which the meaning of the concepts 'non-executive director' and 'independent contractor' was discussed in order to gather information needed for the classification. The statutory and common law tests were then applied to determine the classification of non-executive directors as independent contractors. The conclusion reached is that resident non-executive directors could qualify as 'independent contractors' for employees' tax and income tax purposes. Non-resident non-executive directors of companies are 'employees' for employees' tax purposes and 'independent contractors' for income tax purposes.

Keywords

Employee, Employees' tax, Independent contractor, Non-executive director, Remuneration

*Prof Linda van Schalkwyk is Divisional head: Taxation in the Department of Accounting, Stellenbosch University, South Africa.

+Mr Rudie Nel is a senior lecturer in Taxation in the Department of Accounting, Stellenbosch University, South Africa.

1. INTRODUCTION

One of the basic principles of any tax system is that individuals should be able to determine the amount of tax payable by them with certainty (Smith, 1950). Cilliers (2006) narrows it down by noting that all taxpayers are entitled to be placed in a position where they are able to reasonably ascertain, before committing to a certain transaction or course of action, the exact area within which they will be trespassing tax legislation.

Paragraph 2(1) of the Fourth Schedule to the Income Tax Act 58 of 1962 (the Act) places a responsibility on an 'employer' who is a resident to deduct or withhold employees' tax from any amount of 'remuneration' paid to an 'employee'. All three of these elements are defined in paragraph 1 of the Fourth Schedule, and all the elements in the definitions of these three words must be complied with before the responsibility to withhold employees' tax takes effect.

Legally, the terms 'employee' and 'independent contractor' are mutually exclusive and are direct opposites (SARS, 2010). Frago and Kleiner (2005:148) confirm this by saying that 'independent contractor' is just another term for a person who does not have the legal status of an employee. This implies that no employees' tax needs to be deducted or withheld from amounts paid to independent contractors. The specific exclusion contained in sub-paragraph (ii) of the definition of 'remuneration' in the Fourth Schedule to the Act confirms this by excluding amounts paid to independent contractors from remuneration.

The South African Revenue Service (SARS) also clearly states that not only does the responsibility to deduct employees' tax rest on the employer, but it is also the employer that is in the best position to evaluate the facts and the actual situation in order to confirm a person's status as an independent contractor (SARS, 2010). Dann (1998) describes the issue of whether a person is employed as an employee or an independent contractor as one of the grey areas in the Act. SARS (2010:2) acknowledges that the statutory concept of an 'independent trader' is similar to the common law concept of an 'independent contractor' and that it still remains one of the more contentious features of the Fourth Schedule to the Act.

Due to the contentious nature of the concept 'independent contractor', an employer, therefore, faces the risk of 'trespassing' tax legislation (even if unintentionally) by making an incorrect classification of a person rendering services as an independent contractor. The incorrect classification would result in the employer not deducting the required employees' tax and could hold the following implications for the employer:

- personal liability for the payment to SARS of the amount of employees' tax not deducted as required (paragraph 5(1) of the Fourth Schedule to the Act);
- guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding 12 months (paragraph 30(1)(a) of the Fourth Schedule to the Act);
- penalty of 10% of the amount due (paragraph 6(1) of the Fourth Schedule to the Act as amended and Chapter 15 of the Tax Administration Act); and
- liability for interest in terms of section 89(bis)(2) of the Act.

The importance of the correct classification by an employer is therefore evident. However, such classification is not a clear-cut case. De Koker (2009) describes the distinction between employee and independent contractor as a murky one and says that in practice it is often difficult to decide whether the person remunerated is being remunerated in the course of an

independent trade or as an employee. Although it is recognised that employers faced with the uncertain classification would rather err on the side of caution and deduct the employees' tax, clarity regarding the classification of non-executive directors (NEDs) should be provided.

The third King Report on Corporate Governance for South Africa and its accompanying Code of Governance Principles for South Africa issued by the Institute of Directors in 2009 (collectively referred to as 'King III') placed, *inter alia*, the spotlight on the composition of the board of directors and the roles of non-executive directors. The independence of NEDs and the remuneration of directors are two of the principles discussed in Chapter 2 of King III (Institute of Directors, 2009). Whether independent NEDs as described in King III will be classified as independent contractors for the purposes of the Act (meaning for income tax purposes) as well as for the purposes of the Fourth Schedule to the Act (meaning for employees' tax purposes) respectively, is not addressed in King III and is the focal point of this article.

Furthermore, the classification of an NED as an independent contractor for income tax purposes will not necessarily be the same as for employees' tax purposes. Based on the classification as either an employee or an independent contractor, different tax implications will follow. These are summarised in TABLE 1.

TABLE 1: The implications of classification

<i>Implication</i>	<i>Classification of NED as</i>	
	<i>Employee</i>	<i>Independent contractor</i>
Employees' tax: Obligation to deduct from payment made	Obligation on employer to deduct employees' tax on amounts paid to NED	No obligation on company to deduct employees' tax on amounts paid to NED
Income tax: Deductions limited in terms of section 23(m)	Section 23(m) of the Act will be applicable to the NED and the allowable deductions against remuneration limited	Section 23(m) of the Act will not be applicable to the NED and the limitations in respect of deductions will not apply
Income tax: Obligation to register as provisional taxpayer	No obligation on the NED to register as not considered to be a provisional taxpayer (directors' fees will constitute remuneration)	The NED is required to register as provisional taxpayer (directors' fees will not constitute remuneration)
VAT: Obligation to register as VAT vendor, which will impact on the amounts to be included or deducted for income tax purposes	No obligation on the NED to register as VAT vendor. NED is not deemed to be carrying on an enterprise to the extent that the directors' fees are remuneration (proviso (iii)(aa) to 'enterprise' in the VAT Act 89 of 1991)	If the annual directors' fees exceed the threshold for registration, the NED must register as VAT vendor since he holds an office (proviso (iii)(bb) to 'enterprise' in the VAT Act 89 of 1991)

Source: *Income Tax Act (58/1962) and Value added Tax Act (89/1991)*

In addition to the above implications, the impact on NEDs in practice could also be far-reaching. With reference to companies listed on the Johannesburg Stock Exchange (JSE) it was noted that 66% of all directors are NEDs and the number of NEDs of these companies increased by 13.2% since 2002 (PwC, 2012).

Therefore, considering the number of NEDs currently in South Africa and the contentious nature of the classification as 'independent contractor', there is a need to achieve greater clarity on the classification. This article also considers the position of both resident and non-resident NEDs as employees or independent contractors for both income tax and employees' tax purposes.

2. RESEARCH OBJECTIVE, RESEARCH METHOD AND VALUE OF RESEARCH

The objective of this article is to determine whether NEDs (both resident and non-resident) are employees or independent contractors for income tax and employees' tax purposes, respectively. A distinction is made between resident and non-resident NEDs. Achievement of this objective necessitates the answering of the following research questions:

- What does the term 'non-executive director' mean and what are their duties and responsibilities?
- What does the term 'independent contractor' mean and what type of service contract is applicable to them?
- Do the fees paid to NEDs constitute 'remuneration' as defined in the Fourth Schedule to the Act?
- How is it determined whether a person rendering services is an independent contractor for income tax purposes and employees' tax purposes, respectively?

The research method adopted consists of a literature review of the definitions of 'non-executive director', 'independent contractor', 'employee' and 'remuneration'. Literature includes the relevant provisions of the Act, Interpretation Note No.17 (Issue 3), King III, the Companies Act 71 of 2008 (the Companies Act), published articles, reports and text books relating to the objective.

Details regarding NEDs contained in King III will not be analysed in detail, but serve merely as an indicator of the importance of the correct classification of this specific group of persons rendering services, and as background support for their independence. The interpretation of legislation is dependent on the specific facts and circumstances of individual cases. This article would not attempt to consider all possible facts and circumstances, as this is not considered feasible.

The uncertainty regarding the classification should be clarified to provide certainty and guidance to both employers and NEDs. Although anecdotal evidence (La Grange & Comminos, 2012) has suggested the possible classification of NEDs as independent contractors, no academic literature currently provides a complete view or has addressed the question from both the perspective of income tax and employees' tax. Furthermore, there will also be a distinction made between resident and non-resident NEDs. The contribution of this article is to provide such academic literature with clarity and guidance relating to the topic.

3. MEANING OF 'NON-EXECUTIVE DIRECTOR'

Dictionaries and King III alike emphasise the independence of NEDs. Business Dictionary (2012) defines an NED as:

Non-working director of a firm who is not an executive director and, therefore, does not participate in the day-to-day management of the firm ... Also called external director, independent director or outside director.

King III (2009:Annex 2.3) states that:

Not being involved in the management of the company defines the director as non-executive. NEDs are independent of management on all issues including strategy, performance, sustainability, resources, transformation, diversity, employment equity, standards of conduct and evaluation of performance.

The term NED therefore means a director who

- does not participate in the day-to-day management of a company; and
- is completely independent of management on all issues.

According to Roberts, McNulty and Stiles (2005), this independence implies the ability of NEDs to see things differently. King III (2009) elaborates on the independence of NEDs and states that the majority of NEDs should be independent, as this reduces the possibility of conflicts of interest and promotes objectivity. Further remarks in King III (2009:par.67) about independent NEDs which clearly underline the importance of their independence are that they:

- have not been employed by the company or the group of which it currently forms part in any executive capacity, or appointed as the designated auditor or partner in the group's external audit firm, or senior legal adviser for the preceding three financial years;
- are not members of the immediate family of an individual who is, or has during the preceding three financial years, been employed by the company or the group in an executive capacity;
- are not professional advisers to the company or the group, other than as a director; or
- do not receive remuneration contingent upon the performance of the company.

La Grange and Comninos (2012) confirm the independence of NEDs by pointing out that NEDs are appointed to perform an oversight responsibility for the shareholders and that they must act in an independent manner when considering the conduct of a company.

According to Seegers (2008), NEDs have duties and responsibilities imposed on them by statute and by common law, the most important being to:

- act in the interests of the company;
- exercise an independent discretion in the conduct of the company's affairs;
- avoid conflicts of interest and not to make secret profits; and
- gather information to exercise their independent judgement in the company's interests.

La Grange and Comninos (2012) also describe the function of NEDs as to constructively challenge management and examine the corporate affairs of the company to ensure that sound corporate governance is adhered to, objectives are achieved and the long-term corporate strategy is attained.

Business Dictionary (2012) states that NEDs are usually involved in planning and policy-making, and are expected to monitor and challenge the performance of the executive directors and the management and take a determined stand in the interests of the firm and its stakeholders. King III (2009) confirms the aforementioned by stating that the NED plays an important role in providing objective judgement independent of management on issues facing the company. According to Roberts, McNulty and Stiles (2005) NEDs should bring to the board their past experience, which, together with their distance from the day-to-day running of the company, allows them to offer different perspectives from executives on strategic decisions.

The complete independence and objectivity of NEDs does not necessarily guarantee that the person will be seen as an 'independent contractor' for the purposes of income tax and employees' tax, respectively. It is, however, submitted that this independence will strengthen the case for classifying an NED as an independent contractor and weaken the case for classifying an NED as an employee.

4. MEANING OF 'INDEPENDENT CONTRACTOR'

SARS (2010:9) explains in Annexure C to Interpretation Note No. 17 (Issue 3) that an independent contractor is a colloquial term for a small-time sub-contractor. It further explains that an independent contractor is merely another word for 'entrepreneur', or perhaps, 'employer' (or potential employer). The word 'independent' refers to independence in respect of the employer's organisation, as well as in respect of the employer's control (SARS, 2010:19). In distinguishing between an employee and an independent contractor, one must commence with an analysis of the written employment contract and establish whether the object is the acquisition of *productive capacity* or the *result of productive capacity* (SARS, 2010:23; own emphasis).

The essence of a contract with an employee (*locatio conductio operarum* / contract of service) is the placing of one person's services or *productive capacity* at the disposal of another, thereby enabling the acquisition of that service itself and not simply the fruits of that productive capacity (SARS, 2010:19-20). Kondrasuk, Reed and Jurinski (2001) confirm that, in the case of an employee, the employer controls the employee regarding both results and the methods of achieving those results. Frago and Kleiner (2005:139) note that workers are 'employees' if the employer they work for has the right to direct and control the way they work, including the final results and the details of when, where and how the job is accomplished.

In contrast to the contract with an employee, a contract with an independent contractor (*locatio conductio operis* / contract for services) is a contract in terms of which it is not the services as such which are the object of the contract, but the *result of the services (productive capacity) as a whole*. The client is therefore not interested in the personal services or the labour as such, but in the product or result of such labour (SARS, 2010:19-20). In essence an independent contractor commits himself to deliver the product or end result of his productive capacity. The main differences between the different contract types of employees and independent contractors are summarised in TABLE 2.

The common law concept of an independent contractor also focuses on the distinction between merely achieving an end result (indicative of an independent contractor) and being subject to requirements about how to achieve the end result (indicative of an employee) (Zimmerman & Gowan, 1999). Frago and Kleiner (2005) state that the general rule is that an individual is an

independent contractor if his client has the right to control the results of the work but not the means and methods of accomplishing it.

TABLE 2: Main differences between types of contracts

<i>Description</i>	<i>Employee</i>	<i>Independent contractor</i>
Type of contract	<i>Locatio conductio operarum</i>	<i>Locatio conductio operis</i>
Description of contract	Contract to make productive capacity available	Contract for the results of productive capacity

Source: Annexure C to Interpretation Note No. 17 (Issue 3)

In terms of King III (2009) the appointment of an NED should be formalised in an agreement between the company and NED. However, it is recognised that formal service contracts for the NEDs are not a prerequisite for compliance with King III and where no service agreements exist, this fact should only be disclosed (PwC, 2012). It could therefore be that an analysis of the written service agreement of an NED cannot be the starting point of the classification as advised by SARS (2010) due to the non-existence of such an agreement. Therefore, as there are no standardised employment contracts (if any) for all NEDs, it will be considered whether, in principle, NEDs make available their *productive capacity* or *the result of their productive capacity* to the company.

NEDs should be active contributors by attending all meetings and providing meaningful input into the challenges facing companies (Institute of Directors, 2011; PwC, 2012). Contribution is also considered as one of the key pillars of the fee-setting process for NEDs (PwC, 2012). This warrants merit to the argument that NEDs are providing their independent input to the management of the company, and in doing so are rewarded for the result of their productive capacity. This is indicative of NEDs being independent contractors. NEDs are therefore not making their productive capacity available to the company, as would be the case with employees, and can therefore not be classified as an employee based on the service agreement.

Although the type of contract is considered to be relevant in the classification as an independent contractor, it is not considered to be decisive in the classification of NEDs as independent contractors. A further analysis of the definition of 'remuneration' in the Fourth Schedule and of the provisions of Interpretation Note 17 (Issue 3) is warranted in concluding on such classification.

5. 'REMUNERATION' AS DEFINED IN FOURTH SCHEDULE

Before any amount paid to a person is subject to the deduction of employees' tax, an employer-employee relationship must exist and the amount must be 'remuneration' (paragraph 2(1) Fourth Schedule to the Act). Both the definitions of 'employer' and 'employee' in the Fourth Schedule to the Act emphasise the importance of the fact that the amount paid and received must be 'remuneration' by providing that:

- an employer is a person who pays 'remuneration' to any person; and
- an employee is any person who receives any 'remuneration'.

The definition of 'employee' specifies six types of persons qualifying as an employee in paragraph (a) to paragraph (g) (paragraph (f) was deleted with effect from 1 March 2009). NEDs could be classified as employees in terms of either paragraph (a) or paragraph (g). Paragraph (a) states that any person who receives any remuneration or to whom any remuneration accrues is an employee. Paragraph (g) states that any director of a private company who is not otherwise included in terms of paragraph (a) is an employee. It therefore follows that for an NED to be classified as an employee in terms of par (a) it must be proved that the directors' fees paid to him constitute remuneration.

The definition of 'remuneration' lists specific types of amounts paid to any person which constitute remuneration whether (or not) it was paid in respect of services rendered, and describes eight other specific inclusions and four specific exclusions. Seegers (2008:28) clarifies that NEDs do not receive a salary, but receive directors' fees normally approved in advance at the annual general meeting. As a starting point the word 'fee' is specifically included and therefore the directors' fees of NEDs constitute remuneration, provided that these amounts are not excluded in terms of exclusion rule (ii) in the definition of 'remuneration'.

Exclusion rule (ii) in the definition of 'remuneration' serves to exclude from remuneration any amounts paid in respect of services rendered or to be rendered by certain persons in the course of any trade carried on by them independently of the person by whom such amount is paid and of the person to whom such service is rendered. If a person is classified as an independent contractor, amounts paid to such a person are excluded from the employees' tax net *via* exclusion rule (ii). The following persons are specifically excluded from the ambit of exclusion rule (ii):

- non-residents; and
- employees contemplated in par (b), (c), (d), (e) or (f) of the definition of 'employee'.

In principle, NEDs are not employees as contemplated in par (b), (c), (d), (e) or (f). The exclusion of non-residents from exclusion rule (ii), however, has a fundamental impact on non-resident NEDs. These directors are not able to apply exclusion rule (ii) to prevent directors' fees paid to them from being classified as remuneration. Directors' fees paid to non-resident NEDs will therefore constitute remuneration for employees' tax purposes. Consequently there will always be an obligation to deduct employees' tax on directors' fees paid to non-resident NEDs who are natural persons rendering services in their personal capacities (Wellsted, 2007:28). Non-resident NEDs can, however, be classified as independent contractors for the purposes of income tax, since exclusion rule (ii) affects employees' tax only.

The wording of exclusion rule (ii) provides the two tests (the common law test and the statutory test) to classify a person as either an independent contractor or an employee for employees' tax purposes. To assist employers and SARS officials to classify a worker efficiently and effectively, Interpretation Note No. 17 (Issue 3) (SARS, 2010:2-3) explains the working of both the common law test and the statutory tests. The common law test is applied in the classification of a person for both income tax and employees' tax purposes, whereas the statutory tests are applicable only to the classification of a person for employees' tax purposes. The tests contained in exclusion rule (ii) should be applied in a specific order as specified in Interpretation Note No. 17 (Issue 3) (SARS, 2010:3).

It has already been determined that exclusion rule (ii) does not apply to non-resident NEDs. To determine whether exclusion rule (ii) is applicable to directors' fees received by resident NEDs, a

detailed analysis of the wording of the following tests contained in exclusion rule (ii) (followed by an illustration in FIGURE 1) is required:

- Statutory tests. These factual tests are contained in the provisos to the exclusion rule (ii) and are used to conclusively determine whether an individual must be classified as an independent contractor (*via* the ‘independence test’ contained in proviso (ii)) or as an employee (*via* the ‘employee test’ contained in proviso (i)) for employees’ tax purposes.
- Common law test. This test is referred to as the ‘dominant impression test’. It is applied as a tie-breaker in cases where the statutory tests do not conclusively deem a person to be an independent contractor or employee.

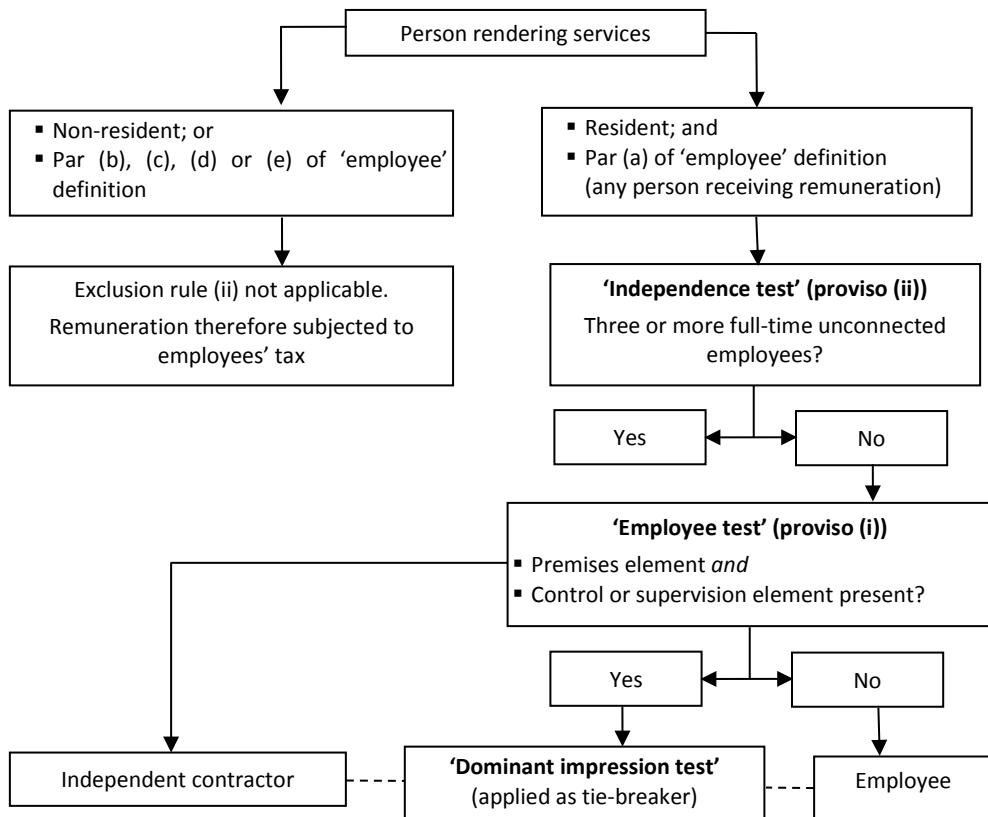


FIGURE 1: Exclusion rule (ii) in definition of ‘remuneration’

Source: Authors’ summary of guidance provided in Interpretation Note No. 17 (Issue 3)

In order to conclude on the status of a resident NED as either an ‘employee’ or an ‘independent contractor’ for employees’ tax purposes, each of the three tests (independence, employee and dominant impression) will now be considered separately in the order specified above.

5.1 Independence test (proviso (ii))

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.

As shown in FIGURE 1, although the independence test is contained in the last proviso to exclusion rule (ii), it supersedes the employee test and the dominant impression test (common law test) and should be considered first for practical purposes.

In terms of this test a person is conclusively deemed to be an independent contractor if he employs three or more full-time employees who are not 'connected persons' to himself or herself in his or her business. It therefore follows that such a person is an independent contractor for employees' tax purposes even if the person is a common law employee or the statutory employee test is satisfied.

King III and the Companies Act are silent on the rights of directors to delegate their responsibilities as NEDs to other persons. It is submitted that for NEDs to provide informed and independent input in meetings, logic dictates that the NEDs would have to provide their services as NEDs personally and would therefore not be able to delegate the rendering of such services to another person. Resident NEDs rendering services in their personal capacity would therefore have no need to employ three employees to render services on their behalf in their business as NEDs. It is submitted that the independence test would not be in the affirmative with reference to resident NEDs.

It follows that resident NEDs would not conclusively be deemed to be independent contractors in terms of the independence test contained in proviso (ii). Consequently the employee test (5.2) and dominant impression test (5.3) must be considered.

5.2 Employee test (proviso (i))

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 conclusively determines if a person is an employee and comprises two elements:

- the 'premises' element; and
- the 'control or supervision' element.

As Clegg (2009) rightly argues, the premises and the control or supervision elements are conjunctive: both must be applicable in order for a person who is rendering independent services in a legal sense to be regarded as an employee for employees' tax purposes. Both these elements should therefore be considered with reference to a resident NED in order to determine whether he or she would conclusively be deemed an employee for employees' tax purposes.

5.2.1 The premises element

The premises element will be present if the services are required to be performed mainly at the premises of the person by whom an amount for services rendered is paid or payable or of the person to whom such services were or are to be rendered.

The Act specifies that the services must be *required* to be performed mainly at the premises. If the resident NED has an employment contract with the company and it specifies that the resident NED's services are not *required* to be performed mainly at the premises of the company, the premises element would not be in the affirmative. It is, however, recognised that some NEDs might not even have service agreements with the company (PwC, 2012:24). Therefore, it should be established whether, in principle, a resident NED performs services mainly at the premises of the company.

The Free Dictionary (2012) defines 'mainly' as: '*for the most part; to the greatest extent; principally*'. Determining whether (or not) resident NEDs actually perform the greatest extent of their services at the premises of their companies would be possible. Seegers (2008) is of the opinion that, in general, it is not necessary for NEDs to perform their services mainly at the premises of the company, as attendance at board meetings and committee meetings is only a part of the functions that they must perform in order to fulfil their obligations. King III (2009) also recognises that the responsibilities of NEDs extends beyond attending meetings. NEDs should also devote time to developing and refreshing their knowledge to remain well-informed about the company (PwC, 2012). Section 74(1) of the Companies Act also allows directors, subject to approval, to vote on decisions by means of electronic communication (without being present in person at meetings). In theory this illustrates that NEDs could also provide their input to meetings without attending meetings in person.

It is submitted that, although the services of resident NEDs are to some extent performed during board meetings which are usually held at the premises of the company, there is merit in the argument that attending these meetings would not represent the greatest extent of their services as NEDs. It is consequently unlikely that services rendered by a resident NED would meet the requirements of the premises element.

If the premises element does not apply to a resident NED, there is no need to consider the control or supervision element, since both elements must exist for the employee test to be applicable. The dominant impression test (refer 5.3) should then be applied to determine whether a resident NED is an employee or an independent contractor. If, however, the premises element does apply to a resident NED, it must be determined whether the control or supervision element is applicable, and this is discussed for the sake of completeness only.

5.2.2 The control or supervision element

The control or supervision element will be present if 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 or her hours of work. The double 'or' in this element therefore leads to four possible instances in which this element will apply:

- control of manner or
- control of hours; or
- supervision of manner; or

- supervision of hours.

Control and supervision are also two of the possible indicators that are used to form the common law dominant impression test (refer to 5.3) of whether a person is an employee or an independent contractor. The difference, however, is that the legislator has elevated these two indicators to form part of the strict statutory employee test which conclusively determines whether the person is an employee while there is no conclusive test under the common law (SARS, 2010). Interpretation Note No. 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). In the case of a resident NED, no control of the productive capacity is acquired, as only the product or result of the productive capacity is acquired (refer to discussion in 4). Therefore the control indicator would not be present in the case of a resident NED.

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). SARS (2010) also indicated that any form of supervision must flow from the legal relationship itself (the contract) and that supervision in the sense of the mere monitoring of performance (without the right to intervene) is unlikely to be relevant. The required independence of NED as discussed in 3 above emphasises and confirms that any supervision by the company will be a mere monitoring of performance without the right to intervene, and such supervision is therefore unlikely to be relevant. Supervision (as envisaged by SARS) of the manner or the hours of work of a resident NED is therefore inconceivable.

Based on the aforementioned it is submitted that neither the manner in which resident NEDs perform their duties, nor the hours of work rendered by resident NEDs are subject to either the control or the supervision of the company. Seegers (2008) seems to support this view by saying that NEDs are by nature independent, do not have an employment contract with the company regulating their hours of work, and nor are they supervised by the company. While they are accountable to the company for their actions as directors, their duties and responsibilities are prescribed by law and not by contract. The effect of the statutory tests on the classification of NEDs is summarised in TABLE 3.

TABLE 3: Effect of the statutory tests on the classification of NEDs

<i>Description</i>	<i>Resident NEDs</i>	<i>Non-resident NEDs</i>
Independence test (refer to 5.1)	Not conclusively deemed to be an independent contractor because the NED renders services in personal capacity and would therefore have no need to employ three or more employees	Not applicable, as non-residents are excluded from the ambit of exclusion rule (ii)
Employee test (refer to 5.2)	Not conclusively deemed to be an employee because the requirements of neither the premises nor the control or supervision elements are met	Not applicable, as non-residents are excluded from the ambit of exclusion rule (ii)

Description	Resident NEDs	Non-resident NEDs
Employees' tax classification based on statutory tests	Not conclusively an employee or an independent contractor. Therefore dominant impression test (5.3) should be considered	Conclusively classified as an employee
Income tax classification	Dominant impression test (5.3) should be considered since the statutory tests are applicable only for employees' tax purposes	

Source: Conclusion based on submissions under 5.1 and 5.2

Since the statutory tests do not conclusively result in classification as an employee or independent contractor for employees' tax purposes for resident NEDs, the dominant impression test (common law) should be applied (as illustrated in FIGURE 1).

5.3 Dominant impression test (common law test)

The dominant impression test first emerged in South Africa in the case of *Smit v Workmen's Compensation Commissioner 1979(1) SA 51 (A)*. Joubert JA rejected the crude 'control' test and stated that the employer's right of supervision and control is merely one of several indicators (albeit an important one) in favour of a contract of service (an employee contract). It was held in *Liberty Life Association of Africa Ltd v Niselow 1996 17 ILJ 673 (LAC)* that the inquiry should be directed towards the worker's obligations rather than his or her rights, and the extent to which the other party (the employer) acquired rights relating to the use to be made of his or her productive capacity.

Interpretation Note No. 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 (the assessor) 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:

- near-conclusive (indicative of the acquisition of productive capacity);
- persuasive (establishing the extent of control of the work environment); and
- 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 assessors to make the determination. The assessor 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).

For employees' tax purposes, the dominant impression will be the basis for classification of the relationship as either an employee relationship or an independent contractor relationship only if the statutory tests (refer to FIGURE 1) are not complied with in the affirmative (SARS, 2010). For

income tax purposes, the common law test will be used to determine the status of both resident and non-resident NEDs (as indicated in TABLE 3).

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 NEDs in order to determine whether they would be indicative of independent contractor status or employee status. The application will be done in table format (TABLE 4) in order to highlight the conclusion on each indicator.

TABLE 4: Common law dominant impression test indicators

<i>Indicator</i>	<i>Application</i>	<i>Conclusion</i>
Near-conclusive indicators		
Control of manner of working	NEDs may choose which routines to follow in the execution of their duties as NEDs and are not instructed by the company in this regard	Suggests independent contractor status
Payment regime	King III (2009:par.153) provides guidelines indicating that NEDs should receive a base fee, as well as a fee per meeting and recognises that the responsibilities of NEDs extend beyond attending meetings. According to PwC (2012:36), the fees of NEDs could have a fixed component and a variable component with attendance of meetings as a prerequisite for payment ('no show, no pay' philosophy). NEDs should also be compensated with reference to their contribution (PwC, 2012:8). The contribution represents the result of an NED's productive capacity and not the productive capacity itself	Suggests independent contractor status
Person who must render the service	King III and the Companies Act (71/2008) are silent on the rights of directors to delegate their responsibilities as NEDs to other persons. It is submitted that for an NED to provide an informed and independent input in a meeting, logic dictates that the NED will personally have to provide his services as NED and would thus not be able to delegate rendering the services to another person	Suggests employee status
Nature of obligation to work	In terms of King III (2009:par.83) it is expected of NEDs to attend board and board committee meetings and acquire and maintain a broad knowledge of the economic environment, industry and business of the company. However, it has been noted that their duties are of an intermittent nature and they are also not bound to attend all meetings, but should do so whenever reasonably possible (Edward Nathan Sonnenbergs Inc, 2010:219). The focus is therefore on the results of	Suggests independent contractor status

<i>Indicator</i>	<i>Application</i>	<i>Conclusion</i>
	the NED's services and not the acquisition of his productive capacity	
Employer (client) base	King III (2009:par.84) allows NEDs to hold more than one directorship provided that it is reasonable for them to exercise due care and diligence. NEDs are therefore free to build multiple concurrent client bases and are not bound to an exclusive relationship with one employer. NEDs should only apply their minds and not hold more directorships than is reasonable for them to exercise due care (Institute of Directors, 2009:41; PwC, 2012:23). An analysis of the annual reports of the top 40 companies listed on the JSE also indicated that NEDs held a high numbers of directorships in other companies (Seakamela, 2011:56)	Suggests independent contractor status
Risk (Profit and loss)	Section 71(3)(b) of the Companies Act (71/2008) provides for the removal of a director who has neglected, or has been derelict, in performance of the functions as director. NEDs therefore bear the risk of being removed from their position if required duties are not performed (bad workmanship). In addition, NEDs are also paid a fixed fee and therefore also bears the risk of time over-runs as their duties are performed	Suggests independent contractor status
Persuasive indicators		
Extent of Control	NEDs determine their own work and sequence of work. NEDs are not bound by orders of the employer (company) about what work they should do and how it must be done as to ensure their independence	Suggests independent contractor status
Reports	The work of NEDs is not controlled through written or oral reports by the company	Suggests independent contractor status
Training	King III (2009:par.89-91) recommends that new directors (including NEDs) attend a formal induction programme to familiarise themselves with the company's business environment. This induction program is, however, not aimed at providing any training in order to render services as NED. Therefore, it is submitted that companies will not train NEDs to render their services in order to provide informed and valuable input in the management of the companies	Suggests independent contractor status
Productive time (work hours and work week)	This is at the discretion of NEDs and is not controlled by an employer. Edward Nathan Sonnenbergs Inc (2010:219) also submitted that the duties of NEDs are of an intermittent nature. With	Suggests independent contractor status

<i>Indicator</i>	<i>Application</i>	<i>Conclusion</i>
	reference to the application of King III, the Institute of Directors (2011:2) suggests that it is not advisable for companies, other than owner-managed companies, to elect a director or alternate director to serve for an indefinite term. Furthermore, at least one third of NEDs should retire by rotation yearly (Institute of Directors, 2011:2). NEDs are therefore not bound by normal working hours or a work week	

Source: Authors' analysis

Based on the submissions in the aforementioned indicators, 90% of the near-conclusive and persuasive indicators suggest that resident NEDs have independent contractor status for employees' tax purposes. Since the same common law test is applied for both income tax and employees' tax purposes, it is submitted that both resident and non-resident NEDs are independent contractors for income tax purposes in terms of the common law dominant impression test.

6. CONCLUSION

It is recognised that the classification as independent contractor for income and employees' tax purposes remains contentious and even 'murky' (SARS, 2010:2; De Koker, 2009). The objective of this article was to determine whether NEDs (both resident and non-resident) are employees or independent contractors for income tax and employees' tax purposes, respectively. The objective was achieved by concluding on findings relating to the meaning of the terms 'non-executive director', 'independent contractor' and 'remuneration', as well as the effect of the application of the statutory and common law tests to classify a person as either an employee or an independent contractor.

It was found that the term 'non-executive director' means a director who does not participate in the day-to-day management of a company and who is independent of management on all issues. In terms of King III (2009:par.83) it is expected of NEDs to attend board and board committee meetings and to acquire and maintain a broad knowledge of the economic environment, industry and business of the company.

In considering the term 'independent contractor' the written contract of employment was found to be important. A contract with an independent contractor (*locatio conductio operis* / contract for services) is a contract in terms of which it is not the services as such which are the object of the contract, but the *result of the services as a whole*. In essence, an independent contractor commits himself to deliver the product or end result of his productive capacity. It is submitted that NEDs provide their independent input to the management of the company, and in doing so are awarded for the result of their productive capacity, which is indicative of NEDs being independent contractors. NEDs are therefore not making their productive capacity available to the company, as would be the case with employees, and therefore cannot be classified as employees based on the service agreement.

In considering whether the fees paid to NEDs constitute ‘remuneration’ as defined in the Fourth Schedule to the Act, the wording of exclusion rule (ii) in the definition of ‘remuneration’ is decisive. Exclusion rule (ii) provides the two tests (the common law test and the statutory test) to classify a person as either an independent contractor or an employee for employees’ tax purposes. The common law test is applied when classifying a person for both income tax and employees’ tax purposes, whereas the statutory tests are applicable only to the classification of a person for employees’ tax purposes.

After applying the two tests in the sequence specified in Interpretation Note 17 (Issue 3), it is submitted that resident NEDs could qualify as ‘independent contractors’ for employees’ tax and income tax purposes. The statutory tests (5.1 and 5.2) do not conclusively classify a resident NED as an independent contractor or employee for employees’ tax purposes. The common law dominant impression test (5.3) suggests that a resident NED should be classified as independent contractor for both employees’ tax and income tax purposes. Non-resident NEDs are excluded from the application of the exclusion rule (ii) to ‘remuneration’. Therefore non-resident NEDs will be considered as ‘employees’ for employees’ tax purposes and ‘independent contractors’ for income tax purposes (applying the common law dominant impression test).

The findings of this article provide guidance and certainty (it is submitted to a sufficient extent) regarding the classification of NEDs as independent contractors, except in the case of non-resident NEDs for employees’ tax purposes. Conclusions are summarised in TABLE 5.

TABLE 5: Conclusion on classification of NEDs

<i>Description</i>	<i>Resident NEDs</i>	<i>Non-resident NEDs</i>
Employees’ tax classification	Not conclusively an employee or an independent contractor in terms of the statutory tests. Independent contractor status in terms of the dominant impression test (5.3)	Conclusively classified as an employee, since excluded from the statutory tests
Income tax classification	Independent contractor status in terms of the dominant impression test (5.3)	

Source: *Authors’ analysis*

From the findings it is evident that the common law dominant impression test could lend itself to different interpretations and applications. Its contentious nature is aggravated by the fact that SARS places the responsibility to classify a person as either an employee or an independent contractor entirely on the shoulders of an employer. Therefore, it is recommended that consideration should be given to amending paragraphs 5(1), 6(1) and 30(1)(a) of the Fourth Schedule to the Act as well as section 89(bis)(2) of the Act by excluding an employer that incorrectly classifies a person as an independent contractor from personal liability and the offence created by non-compliance with these respective paragraphs.

LIST OF REFERENCES

Business Dictionary. (2012). [Online] Available: <http://www.businessdictionary.com/definition/non-executive-director.html>. (Accessed 6 June 2012).

- Cilliers, C. (2006). The proposed Section 80A(c)(ii) of the Income Tax Act: should it be enacted? *The Taxpayer*, October, pp. 182-187.
- Clegg, D. (2009). *Income Tax in South Africa*. Johannesburg: LexisNexisButterworths.
- Dann, H. (1998). The tax implications of contracting as an independent contractor and or a labour broker. *Meditari Accountancy Research*, 6, pp. 1-17.
- De Koker, A. (2009). *Silke on South African Income Tax*. Johannesburg: LexisNexis Butterworths.
- Edward Nathan Sonnenbergs Inc. (2010). *Corporate Governance 2010: Board structures and directors' duties in 38 jurisdictions worldwide*. [Online] Available: <http://www.ens.co.za/images/news/Corporate%20Governance.pdf>. (Accessed 31 May 2012).
- Fragoso, J.L. & Kleiner, B.H. (2005). How to distinguish between independent contractors and employees. *Management Research News*, 28, pp. 136-149.
- Institute of Directors. (2009). *King Report on Corporate Governance for South Africa*, Institute of Directors in Southern Africa, Johannesburg.
- Institute of Directors. (2009). *Code of Governance Principles for South Africa*, Institute of Directors in Southern Africa, Johannesburg.
- Institute of Directors. (2011). *Practice Notes: The selection, nomination and voting for non-executive directors*, Institute of Directors in Southern Africa, Johannesburg.
- Kondrasuk, J.N., Reed, L.J. & Jurinski, J.J. (2001). The dangers of misclassifying 'employees': Microsoft Litigation emphasizes distinctions between employees and nontraditional workers. *Employee Responsibility and Rights Journal*, 13, pp. 165-173.
- La Grange, J. & Comminos, D. (2012). Directors' remuneration and the concomitant tax issues. *Tax Talk*, 33;20-21.
- Liberty Life Association of Africa Ltd v Niselow* 1996 17 ILJ 673 (LAC).
- PwC. (2012). *Non-executive director's practices and fees trends report 2012*, South Africa: PwC.
- Roberts, J., McNulty, T. & Stiles, P. (2005). Beyond agency conceptions of the work of the NED: creating accountability in the boardroom. *British Journal of Management*, 16, pp. 5-26.
- Seakamela, P. (2011). *An investigation of the concept of independent director with specific reference to the King III Report and how companies listed on the Johannesburg Securities Exchange (JSE) apply the King III codes*. Master's in Business Administration thesis. Stellenbosch University.
- Seegers, G. (2008). PAYE and the non-executive directors. *Taxtalk*, 10, pp. 28-29.
- Smit v Workmen's Compensation Commissioner* 1979(1) SA 51 (A).
- Smith, A. (1950). *The wealth of nations*. Harmondsworth, England: Penguin.
- South Africa. (1962). *Income Tax Act No. 58 of 1962 (as amended)*. Pretoria: Government Printer.
- South Africa. (1991). *Value-Added-Tax Act No. 89 of 1991 (as amended)*. Pretoria: Government Printer.
- South Africa. (2011). *Tax Administration Act No. 28 of 2011*. Pretoria: Government Printer.
- South Africa. (2008). *Companies Act, No. 71 of 2008*. Pretoria: Government Printer.
- SARS, *vide* South African Revenue Service.

South African Revenue Service. (2010). *Interpretation note no. 17 (Issue 3)*. [Online] Available: <http://www.sars.gov.za>. (Accessed 6 June 2012).

The Free Dictionary. (2012). [Online] Available: <http://www.thefreedictionary.com/mainly>. (Accessed 6 June 2012).

Wellsted, A. (2007). Non-resident independent contractors: Deducting PAYE. *Taxtalk*, 8, p. 28.

Zimmerman, R.A. & Gowan, M.A. (1999). Determinants of independent contractor status: Outcomes of U.S. court cases. *Journal of Small Business Management*, 37, pp. 14-27.

