



SOUTH AFRICAN REVENUE SERVICE

INTERPRETATION NOTE NO 5 (Issue 2)

DATE: 23 January 2006

ACT : INCOME TAX ACT, 1962 (the Act)
SECTION : PARAGRAPHS 1, 9(5) and 11C OF THE FOURTH SCHEDULE
SUBJECT : EMPLOYEES' TAX: DIRECTORS OF PRIVATE COMPANIES (WHICH INCLUDE PERSONS IN CLOSE CORPORATIONS WHO PERFORM FUNCTIONS SIMILAR TO DIRECTORS OF COMPANIES)

1. Purpose

This Note has been amended to incorporate the relief measure [insertion of subparagraph (6) into paragraph 11C of the Fourth Schedule to the Act by section 85(1)(d) of the Revenue Laws Amendment Act No 45 of 2003], which was introduced with effect from 1 March 2004 to exclude the formula-based approach in respect of directors of private companies earning more than 75% of remuneration in the form of fixed monthly payments. This amendment was necessary due to the complex method of determining the employees' tax imposed on these directors who received remuneration on the same basis as ordinary employees. This Note also incorporates other amendments effected by section 85(1) mentioned above.

2. Background

Prior to 1 March 2002 directors of private companies were excluded from the employees' tax (PAYE) system of tax collection as they did often not receive regular remuneration throughout the tax year. Instead, they often drew on their loan accounts until their remuneration

was finally determined at the end of the tax year or in the following tax year.

This meant that these directors could settle their income tax liabilities in three payments over an 18-month period *via* the provisional tax system. They, therefore, enjoyed an advantage over other employees who were required to settle their income tax liabilities by way of monthly PAYE deductions.

Experience indicates that persons from whom employees' tax is not deducted, and who do not make adequate provision for their tax liabilities, often fall into arrears and have great difficulty in settling the arrears while paying their current tax liabilities. This not only delays the flow of funds to the fiscus but also adds significantly to the cost of collection of the taxes to the fiscus, which is ultimately passed on to all taxpayers.

In his 2001 Budget Speech, the Minister of Finance announced an investigation into the possibility of bringing directors of private companies into the PAYE tax collection system. This resulted in a feasibility study being conducted and subsequent amendments to the Fourth Schedule to the Act (the Fourth Schedule) which came into operation with effect from 1 March 2002.

Generally directors do not receive regular, fixed remuneration and the determination of their remuneration was often postponed until after the end of the year of assessment. It was found that the most practical way of determining and collecting PAYE in respect of directors' remuneration in the current year of assessment is by calculating the PAYE by way of a formula on the actual remuneration paid or payable to them in a previous year of assessment.

3. The law

The Fourth Schedule was amended to provide for the following:

3.1 Definitions

3.1.1 A director of a private company is specifically included in the definition of “employee” in the Fourth Schedule to ensure that the director is treated as such for PAYE purposes.

3.1.2 Paragraph (vii) of the definition of “remuneration” has been deleted to no longer exclude the remuneration of directors of private companies from the definition.

3.1.3 The definition of a “director” in section 1 of the Act includes a person who, in respect of a close corporation, holds any office or performs any functions similar to the functions of a director of a company other than a close corporation. The definition of a “company” in section 1 of the Act includes a close corporation. In terms of section 38(2)(b) of the Act, a close corporation is not recognised as a public company by the Commissioner. It is therefore treated as a private company for income tax purposes in terms of section 38(3) of the Act.

3.2 Paragraph 11C

Paragraph 11C was inserted into the Fourth Schedule to calculate the director’s remuneration based on a formula where the director’s actual remuneration cannot be determined. With effect from 1 March 2004 (as explained in paragraph 1 above) a relief measure was introduced by way of the insertion of subparagraph (6) into paragraph 11C in respect of directors of private companies earning more than 75% of their remuneration during the previous year of assessment as fixed monthly payments.

3.3 Deduction of employees’ tax from a director’s remuneration

Paragraph 9(5) of the Fourth Schedule states that the determination of employees’ tax to be deducted from the

remuneration of a director must take into account the deemed employees' tax to be determined in terms of paragraph 11C(2) and paid by the company to the Commissioner.

3.4 Liability of private company for deemed employees' tax

Subject to paragraph 11C(6), paragraph 11C(2) of the Fourth Schedule states that every private company must on a monthly basis pay to the Commissioner an amount deemed to be employees' tax in respect of every director. The amount of employees' tax must be determined in accordance with paragraph 11C(3) of the Fourth Schedule.

3.5 Determination of deemed employees' tax

Paragraph 11C(3) of the Fourth Schedule states that the deemed employees' tax payable by the company in terms of paragraph 11C(2) of the Fourth Schedule must be determined on an amount of remuneration deemed to have been received by a director, as contemplated in paragraph 11C(1) of the Fourth Schedule.

3.6 Calculation of deemed remuneration

Paragraph 11C(1) of the Fourth Schedule deems a director to have received a minimum amount of remuneration every month from the company. This minimum amount is determined by the formula:

$$Y = T / N$$

in which:

'Y' represents the monthly amount to be determined;

'T' represents the remuneration of the director paid or payable by that private company in respect of the last year of assessment of that director, provided that:

- (i) If the remuneration for the last year of assessment (referred to in symbol 'T' above) has not been determined as yet, then the remuneration of the preceding year must be used, but it must be increased by an amount equal to 20 per cent of that remuneration.
- (ii) If the remuneration for the year preceding the last year of assessment has also not been determined as yet, then the company must request the Commissioner to determine the remuneration for the purposes of the formula.
- (iii) The following adjustments must be made—
 - lump sum payments contemplated in paragraphs (d),(e) and (f) of the definition of 'gross income' in section 1 of the Act must be excluded;
 - gains made on the exercise, cession or release of a right to acquire any marketable security contemplated in section 8A of the Act must be excluded;
 - allowable contributions to pension and/or retirement annuity funds may be deducted [see paragraph 2(4) of the Fourth Schedule]; and
 - in the case of a director over 65 years, the contributions by the director to a registered medical aid scheme may be deducted [see paragraph 2(4) of the Fourth Schedule].

'N' represents the number of completed months in the year of assessment in respect of which 'T' was derived.

Note: Where more than 75% of "T" in the formula consists of fixed monthly payments, the above deeming provisions will not be applicable, with effect from years of assessment commencing on or after 1 March 2004.

3.7 Right of recovery of deemed employees' tax paid by company

Paragraph 11C(4) of the Fourth Schedule gives the company the right to recover, from the relevant director, the employees' tax that it has paid on the deemed remuneration. This paragraph has also been amended by section 85(1)(c) of Revenue Laws Amendment Act No 45 of 2003 to extend the rights of employers to recover tax deducted in the above circumstances from directors.

3.8 Employees' Tax Certificate (IRP 5)

Paragraph 11C(5) of the Fourth Schedule states that the director will not be entitled to receive an employees' tax certificate in respect of the amount of employees' tax paid by the company on the deemed remuneration if the company has not recovered the employees' tax from the director.

3.9 The director derives more than 75% of fixed monthly payments

Paragraph 11C(6) of the Fourth Schedule states that paragraph 11C(2) does not apply to a director of a private company where more than 75% of the amount contemplated in "T" in respect of the last year of assessment, represents fixed monthly payments of remuneration paid by that company to that director.

3.10 Relief for hardship

Paragraph 11 of the Fourth Schedule provides for an application for relief from employees' tax where the employee is experiencing hardship.

4. Application of the law

It is evident that the amended requirements of the Fourth Schedule provide for the following:

4.1 Close Corporations

A member of a close corporation and any person, who, in relation to a close corporation, holds an office or performs functions similar to the office or functions of a director of a company other than a close corporation, is a director of a private company.

4.2 Are the directors different from other employees?

The provisions of the Fourth Schedule that are applicable to other employees apply to a director who is entitled to remuneration as defined in paragraph 1 of the Fourth Schedule. This means that the employer must withhold PAYE from the "remuneration" paid or payable to the director on the same basis as with any other employee.

4.3 The employer's liability for PAYE on the deemed remuneration

It is a requirement that the employer pays monthly PAYE on the deemed remuneration, as calculated by the formula in paragraph 11C(1) of the Fourth Schedule, whether or not the director is entitled to "remuneration" as defined.

4.4 Who is liable for the monthly PAYE?

Where the PAYE on the actual remuneration exceeds the employees' tax calculated on the deemed remuneration, the PAYE on the deemed remuneration must be paid by the

company and the difference must be paid by way of a deduction from the director's actual remuneration. If the converse applies in that the PAYE on the deemed remuneration exceeds the employees' tax on the actual remuneration, the PAYE on the amount deemed to be remuneration must be paid by the company.

4.5 Right of recovery of PAYE paid by the employer

The employer has the right to recover the PAYE on the deemed remuneration from the director. This recovery may, in addition to any other right of recovery, be deducted from any amount which is or may become payable by the employer to the director. However, the company can arrange with the director to recover the PAYE on the deemed remuneration from the director's current remuneration.

4.6 Details on the IRP 5

The remuneration shown on the IRP 5 must be the amount of the actual remuneration which is paid or is payable to the director for the year of assessment.

The amount of PAYE shown on the IRP 5 will be the sum of the PAYE that was deducted from the actual remuneration of the director and the PAYE paid by the company in respect of the deemed remuneration of that director. A director will therefore not be able to deduct the PAYE on the deemed remuneration from any income tax payable by the director where the PAYE was not recovered from the director by the company (see paragraph 28 of the Fourth Schedule).

If a person ceases to be a director but continues to be employed by the company, or an employee is appointed as a director during the year of assessment, then only one IRP 5 needs to be issued for the year.

4.7 Relief for hardship

Relief can be obtained from the Commissioner where there is a verifiable reason for hardship. An application for a tax directive [IRP 3(d)] must be completed. In these situations, the Commissioner has the discretion to issue a directive (IRP 3) to reduce the amount of PAYE payable by the company.

4.8 Provisional tax for the directors

The definition of "provisional taxpayer" in paragraph 1 of the Fourth Schedule has been amended by section 49(1)(a) of the Revenue Laws Amendment Act, No 31 of 2005 to delete items (b) and (bA) from that definition, which means that directors will no longer be required to register as provisional taxpayers merely as a result of being directors of private companies. This amendment will come into operation on 1 March 2006 and applies in respect of years of assessment commencing on or after that date.

4.9 Appointment of director during the year of assessment

Where a person is appointed as a director of a private company during the year of assessment and the director was not previously an employee of that company, PAYE will be payable on the actual remuneration which is paid or is payable to the director during that year of assessment. The formula in paragraph 11C(1) of the Fourth Schedule will not be applied to deem any remuneration to have accrued to the director in the year of appointment. However, where the newly appointed director was previously an employee of the company, the formula will be applicable.

4.10 Termination of directorship

Where the person ceases to be a director but remains an employee of the company, the formula must no longer be used and PAYE must be deducted from remuneration that is actually paid or is payable to the employee.

4.11 SITE versus PAYE

SITE is not deductible from the remuneration of directors because their remuneration is specifically excluded from the definition of "net remuneration" in paragraph 11B of the Fourth Schedule. Employers must therefore only deduct PAYE from the remuneration of these directors.

4.12 Does PAYE paid by the company give rise to a fringe benefit?

The amount of tax that the company pays in respect of the deemed remuneration of each director of a private company is not considered to be a loan granted to that director for the purposes of paragraph 2(f) of the Seventh Schedule to the Act, i.e. it does not give rise to an interest-free loan fringe benefit. It is an amount that the company is liable for in terms of paragraph 11C(2) of the Fourth Schedule.

4.13 Amounts paid to directors after the year of assessment

Circumstances may arise where the remuneration of a director or portion thereof accrues in a year of assessment but the quantum of the remuneration is only determined in a later year. For example, the service contract of a director may provide that the director is entitled to a bonus of 10 per cent of the company's profits for the year ending on 28 February 2003. The financial accounts of the company are only finalised on 30 June 2003 when the quantum of the director's bonus can be determined. As long as the accrual of the bonus is not dependant on any other event which happens after the year of assessment ending on 28 February 2003, the bonus will accrue in the year of assessment ending 28 February 2003. The bonus which is eventually quantified in the 2004 tax year of assessment will not, however, be included in the calculation of the actual remuneration for the determination of PAYE in either of the 2003 or 2004 years of assessment. Instead it will be

included in the calculation of the deemed remuneration for the 2004 year of assessment (which must be re-calculated at the time of determination). The director must include the bonus in question with the IT3 (a) certificate in his/her income tax return for the 2003 year of assessment. This is done in terms of the discretion available to the Commissioner in paragraph 2(1) of the Fourth Schedule.

4.14 Difficulties in determining the deemed remuneration

Where the deemed remuneration cannot be determined in the prescribed manner as a result of the fact that the remuneration of the director has not been determined for the relevant years of assessment, the Commissioner must be approached to make the determination.

4.15 Where more than 75% of the previous actual remuneration consists of fixed monthly payments

In terms of the newly inserted paragraph 11C(6) of the Fourth Schedule the legislator created an exception to the general rule. Where more than 75% of the previous actual remuneration consisted of fixed monthly payments, the employer must ignore the provisions of paragraph 11C of the Fourth Schedule. To determine whether the provisions of paragraph 11C should be ignored, the employer must determine the value of "T" in the formula contained in paragraph 11C(1) of the Fourth Schedule. If, during the same year of assessment on which "T" is based, more than 75% of the value of "T" in the formula was paid by way of fixed monthly payments, the employer must ignore the deemed liability created under paragraph 11C(2) of the Fourth Schedule. In such a case, the employees' tax liability in respect of the director must be determined with reference to the actual remuneration paid or payable to the director by the employer during the current year of assessment.

Refer to the practical example (**Annexure A**) and the flowchart (**Annexure B**).

4.16 New registrations for Employees' Tax

Companies like fixed property companies and investment companies that pay fees to their directors but were not previously registered for employees' tax as they had no employees will now have to register for employees' tax and the skills development levy. However, a company will not be required to register for employees' tax where none of its directors or employees will be liable for normal tax, i.e. where the total remuneration of each director or employee, in a year of assessment, is below the threshold that will result in a liability for income tax.

4.17 Skills Development Levy

As the remuneration of a private company director will fall within the definition of "remuneration" for purposes of the Fourth Schedule, the remuneration must be brought into account in the calculation of the Skills Development Levy with effect from 1 March 2002.

4.18 Regional Services Levy

The current method of calculating the "regional services levy" in terms of the Regional Service Councils Act, No. 109 of 1985 and the KwaZulu and Natal Joint Services Act, No. 84 of 1990 will not be affected by the new legislation for employees' tax for directors of private companies.

4.19 Unemployment Insurance Fund

Directors of private companies fall within the definition of "employee" in the Unemployment Insurance Fund Act, 2002 and have to contribute to the Unemployment Insurance Fund if the remuneration is greater than the Gazetted amount.

4.20 Operational Guideline

A guideline [Operational Guideline - Employees' Tax: Directors of Private Companies (which include persons in close corporations who perform functions similar to directors of companies)] that deals with examples and operational aspects like the application for tax directives is available on the South African Revenue Service website, www.sars.gov.za, under "PAYE".

5. Effective Date

This Interpretation Note is applicable from 01 March 2002.
Paragraph 11C(6) of the Fourth Schedule is applicable from 1 March 2004.

6. Practical Example

See **Annexure A**

7. Flowchart to determine whether paragraph 11C (6) applies

See **Annexure B**

**Law Administration
SOUTH AFRICAN REVENUE SERVICE**

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Example

During the year of assessment ending on 28 February 2006 a director of a private company received the following remuneration:

| | |
|---------------------------------------------------|-----------------|
| Salary | R250 000 |
| Bonus | <u>R 65 000</u> |
| Gross remuneration | R315 000 |
| Less: Retirement annuity fund contributions (RAF) | <u>R 35 000</u> |
| Remuneration ("T" in the formula) | <u>R280 000</u> |

Deemed remuneration

$$Y = T/N$$

$$Y = R280\ 000/12$$

$$Y = R23\ 333$$

Fixed monthly remuneration

| | |
|----------------------------|-----------------|
| Salary | R250 000 |
| Less: RAF | <u>R 35 000</u> |
| Fixed monthly remuneration | <u>R215 000</u> |

75% of "T" in the formula amounts to R210 000 (R280 000 x 75%).

As the fixed monthly remuneration (R215 000) received by the director during the 2006 year of assessment is more than 75% of "T" in the formula (R210 000), employees' tax for 2007 year of assessment must be deducted on the actual remuneration (after the deduction of RAF contributions) received by the director.

Note: If the fixed monthly remuneration for the 2006 year of assessment (after the deduction of RAF) was R205 000 (i. e. **not** more than 75% of "T", which is R210 000), PAYE for the 2007 year of assessment would be required to be deducted according to the tax tables from the deemed remuneration of **R23 333** (R280 000/12) as the fixed monthly remuneration for the 2006 year of assessment was **not** more than 75% of "T" in the formula.

THE TAXATION IMPLICATIONS OF PARAGRAPH 11C(6)

**APPLICABLE TO:
DIRECTORS OF PRIVATE COMPANIES
MEMBERS OF CLOSE CORPORATIONS**

Where "fixed monthly payments" are greater than 75% of "T" in the last year of assessment

Employees' tax is calculated on the actual remuneration

Deeming provisions of paragraph 11C are not applicable

Where "fixed monthly payments" are 75% of "T" or less in the last year of assessment

Employees' tax is calculated on the deemed remuneration in terms of the prescribed formula: $Y = T/N$

Paragraph 11C is applicable