



SOUTH AFRICAN REVENUE SERVICE

INCOME TAX INTERPRETATION NOTE NO. 5

DATE: 19 FEBRUARY 2002

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. Background

Directors of private companies were excluded from the employees' tax (PAYE) system of tax collection mainly because they often do not receive regular remuneration throughout the tax year. Instead, they often draw on their loan accounts until their remuneration is 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 are required to settle their income tax liabilities by way of monthly PAYE deductions.

It is found in practice 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 come into operation with effect from 1 March 2002.

Since directors often do not receive regular, fixed remuneration, and the determination of their remuneration is 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 their 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.

2. **The Law**

The Fourth Schedule has been amended to provide for the following:

2.1 **Definitions**

2.1.1 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.

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

2.1.3 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.

2.2 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.

2.3 Liability of private company for deemed employees' tax

Paragraph 11C(2) of the Fourth Schedule states that every private company shall 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.

2.4 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.

2.5 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.

2.6 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.

2.7 Employees' Tax Certificate (IRP 5)

Paragraph 11C(5) of the Fourth Schedule states that the director shall 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.

2.8 Relief for hardship

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

3. Application of the Law

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

3.1 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.

3.2 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 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.

3.3 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.

3.4 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.

3.5 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 be from future remuneration payable 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.

3.6 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.

3.7 Relief for hardship

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

3.8 **Provisional tax for the directors**

Directors are still required to register for provisional tax. A director of a private company cannot deduct the PAYE paid by the company from the provisional tax payable by the director to the extent that the company has not deducted the PAYE from the director's remuneration.

3.9 **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.

3.10 **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.

3.11 **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.

3.12 **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 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.

3.13 **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 its 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.

3.14 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.

3.15 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.

3.16 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 01 March 2002.

3.17 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.

3.18 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".

4. Effective Date

This Interpretation Note is applicable from 01 March 2002.

**Law Administration
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