

REPORTABLE

IN THE TAX COURT, PRETORIA

Case No: 11564

In the matter of:

Appellant

and

**THE COMMISSIONER FOR THE SOUTH AFRICAN
REVENUE SERVICE**

Respondent

JUDGMENT

29/06/2005

DATE OF HEARING 2/6/2005

SOUTHWOOD J

[1] This appeal is concerned with additional assessments raised in respect of the appellant for the 2001, 2002 and 2003 years of assessment.

Three issues arise for determination –

- (1) Whether the appellant was an independent contractor during the period 1 September 2000 to 30 June 2002 (ie during the 2001, 2002 and 2003 years of assessment) and was therefore entitled to deduct from her income certain expenditure or whether she

received 'remuneration' from the "A" CC ("A") as defined in the 4th Schedule of the Income Tax Act 58 of 1962 ('the Act');

- (2) Whether "B" CC was a 'personal service company' within the meaning of the term as used in the 4th Schedule to the Act; and
- (3) Whether the Commissioner was entitled to apply section 76 of the Act in respect of the 2002 year of assessment regarding an amount of R75 447,28 received by the appellant.

[2] The appellant is a human resources consultant. In October 1999 the appellant was employed by A in that capacity. From 1 October 1999 until 29 February 2000 the appellant worked for A and at the end of the 2000 year of assessment A issued an IRP5 in respect of the appellant.

[3] At the beginning of the 2001 year of assessment the appellant was still employed by A. She continued to render service to the close corporation until 31 August 2001. At the end of the 2001 year of assessment the appellant submitted a return reflecting that she had been employed by A from 1 March 2001 to 31 August 2001 and she attached an IRP5 issued by A in respect of that period reflecting gross remuneration of R125 512, SITE of R4 990,68 and PAYE of R28 355,57. The appellant also submitted financial statements in respect of "C" for the period 1 September 2000 to 28 February 2001. The income and expenditure account reflected income (fees,

commissions and interest received) of R177 928 and expenditure of R129 206, giving a net profit of R48 722 for the period.

[4] At the end of the 2002 year of assessment the appellant submitted a return in which she described herself as a human resources manager/consultant and disclosed taxable income of R141 360. In support of the return the appellant submitted financial statements in respect of "C" for the year ending 28 February 2002. The income and expenditure account reflected income (fees, commissions and interest received) of R426 657 and expenditure of R285 297, giving a net profit of R141 360.

[5] At the end of the 2003 year of assessment the appellant submitted a return in which she stated that her taxable income for the period 1 March 2002 to 30 June 2002 was R71 037 as C and that she had received R121 791 from her employer B CC during the period 1 July 2002 to 28 February 2003. In support of this return the appellant submitted financial statements in respect of C for the period 1 March 2002 to 29 June 2002. The income and expenditure account reflected income (fees, commissions and interest received) of R136 779 and expenditure of R65 742, giving a profit of R71 037. The appellant also submitted an IRP5 issued by B for the period 1 July 2002 to 28 February 2003 reflecting her members remuneration as R121 791.

[6] In 2003 the South African Revenue Service (SARS) carried out an audit of the tax affairs of A. This audit was performed by a SARS auditor, Mr D. Drummond, and related to income tax, VAT and PAYE. When he arrived at A's premises Mrs X, A's bookkeeper, handed to Drummond a copy of the close corporation's general ledger.

[7] The general ledger reflected the following in respect of the appellant –

(1) 2001 year of assessment

(a) During the period July 2000 to February 2001 A paid to the appellant as salary various amounts ranging from about R15 000 to about R23 000;

(b) During the period July 2000 to February 2001 A paid monthly instalments to a medical aid scheme in respect of the appellant.

(2) 2002 year of assessment

(a) During the period March 2001 to June 2001 A paid the appellant a monthly salary of R23 539 and paid the appellant's monthly subscriptions to the social club;

(b) A paid to the appellant bonuses totalling R75 447,28.

[8] Pursuant to this audit SARS issued additional assessments in respect of the appellant for the 2001, 2002 and 2003 years of assessment. The basis of the additional assessments was threefold. First, the fees and commissions received by the appellant during the period 1 September 2000 to 30 June 2002 – when the appellant purported to practise as an independent contractor, C – were remuneration for the purposes of the 4th Schedule and the expenses claimed as deductions from that income were therefore not permissible. Second, the bonus of R75 447,28 received by the appellant during the 2002 year of assessment was not disclosed and was accordingly subject to the penalty provided for in section 76 of the Act. SARS imposed additional tax of 200 %. Third, the appellant's close corporation, B, which commenced business on 1 July 2002 was a personal service company during the period 1 July 2002 to 28 February 2003 and was an employee which received remuneration from A, the employer, in terms of the 4th Schedule.

[9] The appellant and her tax advisor, F testified on behalf of the appellant. Mr Drummond testified on behalf of the respondent.

[10] The appellant testified that she was employed as a human resources consultant by A until September 2000 when she commenced practising independently as C. She practised independently as C until July 2002 when B commenced business. As C she continued to perform services

for A. Nevertheless she regarded herself as completely independent. She did not work fixed hours and she was not subject to A's control. A had no say as to how she conducted her business. She dealt directly with the clients and she regarded these clients as her clients. She usually dealt with clients at the client's place of business but she did have an office at A's premises which she used when necessary. She also used A's conference room. As an independent contractor she did the same work that she did when she was an employee of TPB. She advised clients on employment relationships and related issues and drew up policies and procedures to be used in the workplace as well as in disciplinary proceedings. When she started business in the name of B she continued to perform the same services for A. She said she had no knowledge of the R75 447,28 which the Receiver of Revenue alleged she had received as a bonus during the 2002 year of assessment. She could not say whether she received this amount or not and she did not pertinently deny that it had been received.

- [11] The appellant confirmed that at all times during her relationship with A, whether as employee, independent contractor or as holder of the members' interest in B, she did the same work and used the same *modus operandi*. She negotiated with clients on behalf of A; she entered into agreements with clients on behalf of A; the client and A were the parties in terms of the agreements; the clients paid A for the services which she rendered and A received the full amount payable in terms of the agreements for its own account. In performing the

services required by the agreements the appellant used the infrastructure provided by A – its offices, conference room, telephone, fax and e-mail facilities. Despite the change in her status the appellant never informed the clients they were doing business with either C or B. The appellant also did not disclose her changed status to the clients in any written document such as an invoice or receipt or statement of account. She has no letterheads reflecting the name of C or B. The appellant did not enter into any contracts in her own name or in the name of B. As far as her clients were concerned they were doing business with A. No clients paid the appellant or B directly for any services rendered. The appellant was not able to explain why the clients paid A for the services if she was performing them as an independent contractor. The appellant and A did not enter into a formal written agreement to record their new relationship. She could not explain why amounts were paid to her as salary after she ceased to be an employee or why A effected payment on her behalf to the medical aid scheme. In cross-examination the appellant confirmed that she had received the bonus of R75 447,28. She could not explain why this amount was not reflected in her return for the 2002 year of assessment. She said that her financial advisor, Mr F, must explain this. It is clear that the appellant did not disclose her new status to any client, that she entered into agreements on behalf of A and that she described herself in these agreements as an employee of A.

[12] Mr F testified that he is a tax consultant and accountant. He did not disclose his qualifications. F testified that the appellant was employed by A until her resignation when she consulted him. The appellant wished to start her own business but she was not financially able to do so. Ms G, the holder of the members' interest in A, did not want the appellant to become independent. She did not want to lose business if the appellant practised independently in direct competition with A. F suggested that they come to an arrangement. As far as he knows the appellant and A did reach an agreement. His understanding was that the appellant would continue to render services to clients on behalf of A; the clients would pay A the fees owing; A would use the fees received to cover the costs of the appellant's business; A would pay the appellant a retainer on a time basis and a share of the profits every three months. This agreement was not recorded in writing. According to F this was not necessary because the appellant and G had discussed the matter. From that time he did not regard the appellant as an employee of A. His firm prepared the financial statements submitted by the appellant. It did so from the appellant's books, bank statements and invoices. F advised the appellant to form a close corporation. This advice had nothing to do with income tax. It was to give the appellant protection against creditors. F testified that the appellant had not provided documentary proof that the expenses claimed by her were incurred in the production of income because he and Drummond had agreed that such proof need not be furnished. F did not explain why the bonus of R75 447,28 received by the appellant

during the 2002 year of assessment was not disclosed in the appellant's return.

[13] Mr Drummond, the SARS auditor, denied that he and F had agreed that documentary proof of expenses need not be furnished. He testified that A's bookkeeper, Mrs X, had furnished him with a copy of A's general ledger reflecting amounts paid to the appellant during the 2001 and 2002 years of assessment and that he had absolved A from liability for employee's tax which should have been deducted from the appellant's salary and paid over to the Receiver of Revenue. He did this because there was a possibility that the appellant was an independent contractor. When he conducted the audit of A he found no evidence that PAYE had been deducted from amounts paid to the appellant and there was no exemption certificate.

[14] The appellant and F were poor witnesses. The appellant contradicted herself about whether she had been an employee prior to September 2000. She was extremely vague. She was not able to explain why A's general ledger referred to amounts paid to her as salary. She could not explain the amount of R75 442,28 paid to her in the 2002 year of assessment. She could not deny that she had received this amount and said that F must explain why it was not disclosed in her financial statements for 2002. F attempted to give the impression that he had personal knowledge of the matters about which he testified when it was clear that he did not have such knowledge. He alleged that the

appellant resigned as an employee of A when this was not stated by the appellant. He also testified about the agreement which the appellant reached with A when he was clearly not present. His evidence about the agreement is not consistent with that of the appellant. He avoided the point of questions and gave long rambling answers to questions which called for a simple reply. His evidence that he and Drummond agreed that the appellant need not furnish the information requested by Drummond was so inherently improbable that it cannot be believed even though it was not pertinently put to him in cross-examination.

[15] Drummond's evidence was not criticised and there is no reason not to accept it.

[16] Employee or independent contractor

The appellant's objection to the assessments is based on the fact that during the period 1 September 2000 to 30 June 2002 the appellant was an independent contractor carrying on a trade and was therefore entitled to deduct the expenses reflected in her income and expenditure accounts. As appears from the financial statements which the appellant submitted for each of the years of assessment the appellant wishes to claim various expenses as deductions from her income.

[17] The appellant's evidence that she became an independent contractor is simply not credible and it is not accepted. It is not consistent with the appellant's own evidence about how she continued to work under the name of A. She negotiated, concluded and performed all agreements in the name of A and she referred to herself in the agreements as an employee of A. Despite the fact that she wished to conduct business for her own account she did not tell any of the clients with whom she negotiated and entered into agreements that they were doing business with her and not A. All payments due in terms of the agreements were made to A which paid the appellant at regular intervals amounts which were referred to as salary. The appellant has not produced a single document to show that she did business as an independent contractor. As pointed out by the Commissioner's representative substance must prevail over form. In this regard he referred to ***Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd 1941 AD 369*** at 395-6; ***Zandberg v Van Zyl 1910 AD 302*** at 309; ***Dadoo Ltd and others v Krugersdorp Municipal Council 1920 AD 540*** at 547 and ***Erf 3183/1 Ladysmith (Pty) Ltd & another v CIR 1996 (3) SA 942 (A)*** at 951D-952J.

[18] The next issue to be decided is whether the appellant received 'remuneration' from A within the meaning of the term as used in the 4th Schedule. In terms of paragraph 1 of the 4th Schedule 'employee' means *inter alia* any person (other than a company) who receives any remuneration or to whom any remuneration accrues and 'employer'

means any person who pays or is liable to pay any person any amount by way of remuneration. For purposes of the 4th Schedule therefore, the payment and receipt of remuneration determine whether a person is an employer or employee.

[19] 'Remuneration' is very broadly defined. The relevant part of the definition reads as follows –

'... (A)ny 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, including –

...

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 any 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 –

(aa) ...

(bb) if the amounts paid or payable for his services consist of or include earnings of any description which are payable at regular daily, weekly, monthly or other intervals'

[20] The amounts received by the appellant clearly fell within the ambit of the general part of the definition and it is equally clear that the exclusion in subparagraph (ii) does not apply since A paid the appellant for her services at regular intervals.

[21] The appellant therefore received 'remuneration' from A within the meaning of the term as used in the 4th Schedule.

[22] "B" – a 'personal service company'

The question is whether B was a 'personal service company' within the meaning of the definition in paragraph 1 of the 4th Schedule.

The relevant part of the definition reads as follows –

'Personal service company means any company (other than a company which is a labour broker), where any service rendered on behalf of such company to a client of such company is rendered personally by any person who is a connected person in relation to such company, and –

- (a) ...
- (b) ...
- (c) the amounts paid or payable in respect of such service consist of, or include, earnings of any description which are payable at regular daily, weekly, monthly or other intervals; or
- (d) where more than 80 % of the income of such company during the year of assessment from services rendered, consists of or is likely to consist

of amounts received directly or indirectly from any one client of such company ...

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

[23] The definition of 'company' in section 1 of the Act includes a close corporation and 'connected person' when the company is a close corporation, means *inter alia* any member. The appellant is a connected person and personally rendered the services to A. The evidence shows that the close corporation had only one client, A, which was the source of all the income received by the close corporation. The evidence also suggests that A paid the close corporation at regular intervals. There is no evidence that the close corporation employed more than three full-time employees throughout the relevant period of assessment and the close corporation is therefore not excluded from the definition of personal service company.

[24] It is accordingly found that in respect of the period 1 July 2002 to 28 February 2003 B was a personal service company within the meaning of the term as used in the 4th Schedule to the Act.

[25] Imposition of penalties in terms of section 76 of the Act

When Mr Drummond examined the A general ledger he found that it reflected that a total of R75 447,28 had been paid by A to the appellant as a share of profits received from A.

In a letter to the appellant dated 26 October 2004 SARS pointed out that this amount had not been included in the appellant's taxable income (dossier 87). When he replied to this letter on behalf of the appellant F said the following –

‘The word “profit share” should read as “commission” and was payable to (A) by (B) and not to the taxpayer directly’ (dossier 91).

There was no denial that the amount of R75 447,28 had been received by the appellant and not disclosed in the return.

The appellant and F's evidence did not deal satisfactorily with this issue. Although she eventually admitted receiving the amount the appellant was not able to explain why it had been omitted from her return. She said F would explain but he failed to do so.

There is therefore no reason to interfere with the imposition of the penalty in terms of section 76 in respect of the 2002 year of assessment. On the facts the Commissioner was entitled to apply this section in respect of the amount of R75 447,28.

[26] To summarise the court's findings –

- (1) The appellant was not an independent contractor during the period 1 September 2000 to 30 June 2002 and she received 'remuneration' from A as defined in the 4th Schedule to the Act:
- (2) B was a 'personal service company' within the meaning of the term as used in the 4th Schedule to the Act during the period 1 July 2002 to 28 February 2003:
- (3) The Commissioner was entitled to apply section 76 of the Act in respect of the 2002 year of assessment with regard to an amount of R75 447,28 received by the appellant.

[27] The parties agreed that the court should refer the assessments back to the Commissioner for reconsideration in the light of the court's findings.

[28] The following order is made:

- (1) The appeal is dismissed;
- (2) The appellant's assessments for the 2001, 2002 and 2003 years of assessment are referred back to the Commissioner for reconsideration in the light of the court's findings.

**B.R. SOUTHWOOD
JUDGE OF THE HIGH COURT**

I agree

MR. W.H. GRAVETT

I agree

MR. R.J. HEFFER