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# TAX & EXCHANGE CONTROL ALERT

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### Protecting the silver lining: SCA confirms no employees' tax on preferential awards paid to employees of insolvents

The Fourth Schedule to the Income Tax Act 58 of 1962 (ITA), places an obligation on all employers and representative employers, as defined in the Fourth Schedule, to withhold employees' tax from all remuneration paid to persons who are employees, in terms of the Fourth Schedule. The application of the Fourth Schedule to the ITA and the obligation to withhold employees' tax, arose in the recent reported judgment of *Commissioner for South African Revenue Service v Pieters and Others 2020 (1) SA 22 (SCA)* (Pieters Case). In this matter, the Supreme Court of Appeal (SCA) had to decide whether liquidators ought to withhold employees' tax from payments made to employees under section 98A of the Insolvency Act 24 of 1936 (Insolvency Act).

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## Protecting the silver lining: SCA confirms no employees' tax on preferential awards paid to employees of insolvents

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While the focus of this article is the SCA's interpretation of the provisions of the Fourth Schedule to the ITA, it is necessary to briefly discuss the provisions of the Insolvency Act referred to by the SCA, as set out by the SCA, so that the judgment can be understood in the correct context.

### Facts

The appellants in the Pieters Case were the liquidators of an insolvent transport company which had employed 700 people. Forty-five days after the appointment of the liquidators, the employment contracts terminated under section 38(9) of the Insolvency Act.

Salary entitlements, leave pay and severance pay had accrued to these employees over the course of the liquidation process. The liquidators determined the employees' entitlements and paid amounts owing to them under section 98A of the Insolvency Act.

SARS objected to the liquidation and distribution account (L&D Account) lodged by the liquidators, on the basis that no provision had been made for the payment of employees' tax in respect of the payments by the liquidators made in terms of section 98A of the Insolvency Act.

The Master of the High Court accepted SARS' objection and ordered the liquidators to amend the L&D Account to reflect the employees' tax as administration costs and deduct the actual employees' tax payable from their liquidators' fee.

### SCA's discussion of the applicable Insolvency Act provisions

The SCA explained that where a company is placed into liquidation, employment contracts and associated payments become regulated by the Insolvency Act. Initially, section 38(1) of the Insolvency Act suspends the operation of all employment contracts concluded by the insolvent employer from the date the provisional liquidation order is granted. Unless otherwise agreed by the employee and liquidator, all suspended employment contracts automatically terminate 45 days after the appointment of the liquidator.

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Sections 97 to 102 of the Insolvency Act prescribe the statutory order of preference in which the various creditors of the insolvent company or *concursum creditorum*, are to receive distributions out of the insolvent estate. The SCA quoted section 98A of the Insolvency Act, relevant for purposes of this article, which makes provision for preferential payments to employees and states the following:

*"(1) Thereafter any balance of the free residue shall be applied in paying-*

*(a) to any employee who was employed by the insolvent-*

*(i) any salary or wages, for a period not exceeding three months, due to an employee;*

*(ii) any payment in respect of any period of leave or holiday due to the employee which has accrued as a result of his or her employment by the insolvent in the year of insolvency or the previous year, whether or not payment thereof is due at the date of sequestration;*

*(iii) any payment due in respect of any other form of paid absence for a period not exceeding three months prior to the date of the sequestration of the estate; and*

*(iv) any severance or retrenchment pay due to the employee in terms of any law, agreement, contract, wage-regulating measure, or as a result of termination in terms of section 38; and*

*(b) any contributions which were payable by the insolvent, including contributions which were payable in respect of any of his or her employees, and which were, immediately prior to the sequestration of the estate, owing by the insolvent, in his or her capacity as employer, to any pension, provident, medical aid, sick pay, holiday, unemployment or training scheme or fund, or to any similar scheme or fund."*

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## Protecting the silver lining: SCA confirms no employees' tax on preferential awards paid to employees of insolvents...continued

The key issue that the SCA had to decide was whether the payments made by the liquidators in terms of section 98A of the Insolvency Act are subject to the obligation to withhold employees' tax in the Fourth Schedule to the ITA.

### SCA's judgment on the main issue

As stated above, the key issue that the SCA had to decide was whether the payments made by the liquidators in terms of section 98A of the Insolvency Act (section 98A payments) are subject to the obligation to withhold employees' tax in the Fourth Schedule to the ITA.

The Commissioner for the South African Revenue Service (SARS) argued that the liquidators fell within the definition of 'employer' in the Fourth Schedule where they made section 98A payments and that this was contemplated in the statutory scheme of preference embodied in the Insolvency Act. Alternatively, SARS argued that any departure from the scheme was warranted by paragraph 3(2) of the Fourth Schedule which reads as follows:

*"The provisions of paragraph 2 shall apply in respect of all amounts payable by way of remuneration, notwithstanding the provisions of any law which provides that any such amount shall not be reduced or shall not be subject to attachment".*

(One should note that paragraph 2 of the Fourth Schedule, referred to in paragraph 3(2), is the provision which imposes the obligation on employers and representative employers to withhold and pay employees' tax to SARS.)

The SCA per Majiedt JA, as he then was, held that section 98A payments are preferential payments, not falling within the employees' tax withholding requirements in terms of the Fourth Schedule.

The primary bases for this finding were the following:

- Firstly, that the amendment of the statutory order of preference to include section 98A was done with a "social justice objective aimed at alleviating the plight of employees who are left unpaid by the financial woes of their liquidated employer company."
- Secondly, that this approach was supported by a careful reading of the Fourth Schedule, which demonstrated a legislative intention to exclude liquidators from the definition 'employers' and therefore from the obligation to withhold employees' tax.

Majiedt JA further held that SARS' arguments had to be rejected as it would, amongst other things, "lead to startling anomalies" as otherwise, section 98A payments, would rank ahead of PAYE amounts listed in section 99(1)(b)(ii) of the Insolvency Act, which would be untenable in law.

Turning to an interpretation of the Fourth Schedule, Majiedt JA held that there was evidence of a legislative intention in the express inclusion of a liquidator in the definition of 'representative employer' in the Fourth Schedule and a trustee



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Following the Pieters Case, the position of liquidators and their duty to withhold employees' tax is clear - no employees' tax needs to be withheld from preferential payments made to employees under section 98A of the Insolvency Act.

of an insolvent estate in 'employer'. He supported this interpretation with the legislative history of the provisions – the present definition of 'employer' in the Fourth Schedule was effected in 2008 and that of 'representative employer' in 2014. The legislative intention was held to exclude a liquidator, who constituted a representative employer, from the obligation of withholding employees' tax, under paragraph 2(1) of the Fourth Schedule.

Lastly, Majiedt JA held that paragraph 3(2) of the Fourth Schedule, quoted above and relied on by SARS, was not applicable to the Insolvency Act as it did not provide that any amount shall not be reduced or shall not be subject to attachment. It therefore found no application to section 98A payments.

### Observation

Following the Pieters Case, the position of liquidators and their duty to withhold employees' tax is clear - no employees' tax needs to be withheld from preferential payments made to employees under section 98A of the Insolvency Act.

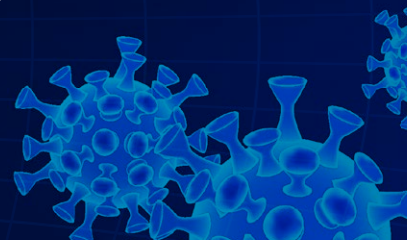
While not explicitly dealt with in the judgment, it is possible that the same principle could apply to other payments listed in section 98A(1)(b) of the Insolvency Act, such as, for example, employer contributions to any pension fund, provident fund, medical aid scheme and so forth. This is because these amounts constitute fringe benefits, which must be included in a person's "remuneration", as defined in the Fourth Schedule to the ITA.

With the economic impact of COVID-19 being felt across the world and particularly in developing countries such as South Africa, it is of course hoped that the measures employed by governments, will mitigate job losses and prevent the closure and liquidation of businesses. However, should the employee of a South African employer be affected by the closure or liquidation of the company he is employed by, such employee can at least know that they will be entitled to the full statutorily prescribed payment, referred to in section 98A of the Insolvency Act.

*Tsanga Mukumba and Louis Botha*

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## OUR TEAM

For more information about our Tax & Exchange Control practice and services, please contact:



**Emil Brincker**  
National Practice Head  
Director  
T +27 (0)11 562 1063  
E [emil.brincker@cdhlegal.com](mailto:emil.brincker@cdhlegal.com)



**Mark Linington**  
Private Equity Sector Head  
Director  
T +27 (0)11 562 1667  
E [mark.linington@cdhlegal.com](mailto:mark.linington@cdhlegal.com)



**Howmera Parak**  
Director  
T +27 (0)11 562 1467  
E [howmera.parak@cdhlegal.com](mailto:howmera.parak@cdhlegal.com)



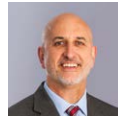
**Gerhard Badenhorst**  
Director  
T +27 (0)11 562 1870  
E [gerhard.badenhorst@cdhlegal.com](mailto:gerhard.badenhorst@cdhlegal.com)



**Stephan Spamer**  
Director  
T +27 (0)11 562 1294  
E [stephan.spamer@cdhlegal.com](mailto:stephan.spamer@cdhlegal.com)



**Jerome Brink**  
Director  
T +27 (0)11 562 1484  
E [jerome.brink@cdhlegal.com](mailto:jerome.brink@cdhlegal.com)



**Ben Strauss**  
Director  
T +27 (0)21 405 6063  
E [ben.strauss@cdhlegal.com](mailto:ben.strauss@cdhlegal.com)



**Petr Erasmus**  
Director  
T +27 (0)11 562 1450  
E [petr.erasmus@cdhlegal.com](mailto:petr.erasmus@cdhlegal.com)



**Louis Botha**  
Senior Associate  
T +27 (0)11 562 1408  
E [louis.botha@cdhlegal.com](mailto:louis.botha@cdhlegal.com)



**Dries Hoek**  
Director  
T +27 (0)11 562 1425  
E [dries.hoek@cdhlegal.com](mailto:dries.hoek@cdhlegal.com)



**Varusha Moodaley**  
Senior Associate  
T +27 (0)21 481 6392  
E [varusha.moodaley@cdhlegal.com](mailto:varusha.moodaley@cdhlegal.com)



**Heinrich Louw**  
Director  
T +27 (0)11 562 1187  
E [heinrich.louw@cdhlegal.com](mailto:heinrich.louw@cdhlegal.com)



**Louise Kotze**  
Associate  
T +27 (0)11 562 1077  
E [louise.kotze@cdhlegal.com](mailto:louise.kotze@cdhlegal.com)

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### JOHANNESBURG

1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa. Dx 154 Randburg and Dx 42 Johannesburg.  
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E [jhb@cdhlegal.com](mailto:jhb@cdhlegal.com)

### CAPE TOWN

11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.  
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E [ctn@cdhlegal.com](mailto:ctn@cdhlegal.com)

### STELLENBOSCH

14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.  
T +27 (0)21 481 6400 E [cdhstellenbosch@cdhlegal.com](mailto:cdhstellenbosch@cdhlegal.com)

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