

Tax pitfalls in supplying labour to clients

A LABOUR broker either makes his own employees available to perform work for a client according to the client's employment needs, or provides workers to a client. The client pays the labour broker for supplying such persons.

Payment made to a labour broker not in possession of an exemption certificate is subject to employees' tax, but often the income-tax consequences for the labour broker are overlooked.

Section 23(k) of the Income Tax Act provides that in determining its taxable income, no deductions may be made by a labour broker who is not in possession of an exemption certificate other than amounts paid to the employees of such labour broker.

A labour broker that is not in possession of an exemption certificate is defined as an employment company under the Income Tax Act 1962. Such a labour-brokering company is subject to tax at a rate of 34% on its taxable income, and worse, s23(k) of the act effectively limits the deductions a labour broker is allowed in the determination of its taxable income to salary cost.

Consider the facts when only a

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small portion of a company's income is received from labour-brokering activities. Could it be said that all the business income would fall within the clutches of s23(k)?

The relevant sections of the act, unfortunately, do not provide for an interpretation to the contrary. To make matters worse, Interpretation Note No 35 of March 7 2006 stipulates that the act does not make provision for the apportionment of deductions where a labour broker is in receipt of more than one type of income, and that if a company falls within the definition of a labour broker the provisions of s23(k) will apply.

Based on the above, once a company is a labour broker as defined, even if the income received from labour-brokering activities represents only a portion of the total income, the limitations imposed by s23(k) would apply to all the income of the company.

Assume Company Y, an IT service provider, as part of its activities provides its employees to clients to assist such clients with skills and capacity shortages the clients may experience in their IT departments. For the provision of the employees,

Company Y receives a fee. About 20% of Company Y's income consists of the provision of IT employees or labour and the balance of the income consists of the provision of independent IT services to clients.

In the above example Company Y, among other things, provides labour and these activities could fall within the definition of a labour broker as defined in the act. Because Company Y is not in possession of a labour-broker exemption certificate (IRP 30), the following consequences should be considered:

- The fee received from clients for the provision of labour would constitute remuneration and would be subject to employees' tax at a rate of 34%;

- Company Y, being a labour broker, could be subject to the restrictions of section 23(k) in that only employment cost may be deducted from all the company's income in the determination of its taxable income; and

- Company Y could be classified as an employment company and taxed at a rate of 34% instead of the corporate tax rate of 29% in respect of all its taxable income.

To overcome the tax consequences mentioned above, the

following could be considered:

- To the extent that a taxpayer provides labour, an exemption certificate should be obtained. It is important to note that a labour broker will not qualify for a certificate of exemption if the labour broker is contractually obliged to provide the client with a specific employee, or subject to certain qualifications, when more than 80% of the labour broker's income is received from any one client; and

- Where the taxpayer does not qualify for an exemption certificate it should consider conducting the labour-brokering activities in a separate entity so as to avoid the consequences mentioned above being applicable to the entire business operation.

An interpretation of the relevant provisions of the act interpretation note 35 could, in practice, result in ambiguity and even lead to absurd results, penalising a bona fide trading concern. It would be interesting to see how our courts, if confronted with the question, interpret the provisions of the act.

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