


Comparison of classification criteria for independent contractors in South Africa to selected developed countries for tax purposes

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ABSTRACT

Complexities and uncertainties frequently arise when a decision has to be made by an employer to classify a worker as an employee or contractor for income tax purposes. This is especially true when the employer seeks to obtain a certain tax benefit from the classification or wishes to avoid carrying out certain administrative duties as an employer on behalf of the employee. The process of applying the classification criteria for employees and independent contractors is not straightforward or clear. This is because the criteria are open for interpretation and therefore subject to possible manipulation or misuse.

The main objective of this study is to compare the classification criteria used in South Africa (in its current form) with those of Australia and Germany when determining the taxation status of an independent contractor in an attempt to establish if there is a more simplified and accurate classification method. The method currently used in this process in South Africa (that is, classification as an independent contractor or an employee) as envisaged by the South African Income Tax Act 58 of 1962 read with Interpretation Note 17 of South African Revenue Services is explored. This is followed by an analysis of the classification criteria used by Australia and Germany in determining the taxation status of independent contractors and employees.

From a South African income tax perspective, the definition of remuneration is a determining factor when establishing who does not qualify as an independent contractor. A person receiving remuneration as defined in the Act is not an independent contractor but an employee. The remuneration received is therefore subject to employees' tax which is withheld by the employer and payable to SARS. In case of uncertainty of the employer-employee relationship, the application of statutory test and common law test is recommended in South Africa. In the cases of Australia and Germany, the relationships employers have with employees and contractors are tested by applying common law only. This process takes into consideration outcomes from existing court cases which dealt with differentiating employees from independent contractors.

The study concludes that the system which applies both the statute and common law in South Africa seems to be more effective than the application of only the common law test in Australia and Germany. The statute in its current form in South Africa can be applied for common cases while the common law test is applied to more complex situations. The use of common law could be minimal if the terms 'independent contractor' and 'carrying on a trade' were clearly defined and incorporated in the Act.

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DEDICATION

I dedicate this work to my lovely mother,

Linah Phaswane Njana

for the love, sympathy, belief and courage that you have shown me at all times.

I have worked hard to make you proud, as I promised you.

LIST OF ABBREVIATIONS

ATO	Australian Tax Office
BCE	Basic Conditions of Employment
CCMA	Commission for Conciliation, Mediation and Arbitration
ICA	Independent Contractor Association
IN	Interpretation Note
LR	Labour Relations
PAYE	Pay-as-you-earn
SABC	South African Broadcasting Corporation
SADTU	South African Democratic Teachers Union
SARS	South African Revenue Service
SDL	Skills Development Levy
SITA	State Information Technology Agency
UIF	Unemployment Insurance Fund
US	United States

KEYWORDS

classification criteria, classification of independent contractors, developed countries, employers withholding taxes, independent contractors, South Africa, taxation status

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CHAPTER 1 INTRODUCTION

1.1 Introduction

Fienberg and Sunjka (2014:1) states that employers typically use a mixed workforce consisting of employees and independent contractors. In terms of Section 213 of the Labour Relations Act 66 of 1995, employees are employed under contracts of employment while independent contractors are persons or companies paid to render a particular service and are not subject to the control or direction of the payer. The reason behind this workforce configuration is the fluctuation in customer demands for products and services offered by the employer. Kenny and Webster (1998:217) state that another reason for this situation is that the majority of workers prefer to work independently of employers. The study conducted by Eberhard et al. (2017:48) also concluded that more workers under traditional contracts of employment are becoming engaged in employment as independent contractors because this allows them to deduct qualifying business expenses themselves from the income they generate when calculating their taxable income, instead of having their tax deducted by their employers.

In terms of the Fourth Schedule to the South African Income Tax Act 58 of 1962 (hereinafter referred to as “the Act”), it is the responsibility of the employer to withhold employees’ tax on remuneration as defined in the Act and pay it over to the South African Revenue Service (SARS). The amount paid to an independent contractor is excluded from the definition of remuneration in terms of the Act. There is no definition of “independent contractor” in the Act. It is the responsibility of the employer to classify an employee as an independent contractor (SARS, 2019:6).

Employment relating to independent contractors has created difficulties in connection with the classification which is determined by applying the criteria in the SARS Interpretation Note 17 (Issue 5) issued on 5 March 2019 (hereinafter referred to as “IN17”). The difficulty arises as the criteria are interpretative in nature and a significant amount of judgement is required in deciding whether or not a worker is an independent contractor. In terms of the common law, someone who is an independent contractor might as well be an employee (Carlson, 2017:178). Carlson (2017:127) state that:

“...in the modern working world, however, employee and independent contractor status is not always clear, especially when the workers work as individuals and are not organised as firms. Individual workers might be “employees”, but they might also be self-employed individuals working as “independent contractors”. Even if it is clear that workers are someone’s “employees”, the identity of the employer can be unclear. If one firm pays “employees” to work mainly or

exclusively for another firm that pays the first firm for the work, which firm is the “employer” of the employees?”

Determining employee and independent contractor status is important because such status is a gateway to many substantive legal rights and obligations (Cherry & Aloisi, 2017:635).

An employer has legal obligations to pay employees remuneration for the work they have completed and the legal rights to withhold tax such as PAYE, SDL or UIF from the remuneration and pay it over to SARS. On the other hand, independent contractors have legal rights to receive income from employers for the work completed and legal obligations to pay tax to SARS on the income they have received. Leberstein and Ruckelshaus (2016:1) and Carby-Hall (2002:7) state that many companies in janitorial, transportation, logistics, construction, domestic and home care and in other sectors, operate on a take-it-or-leave-it basis on contracts with non-standard workers. Cherry and Aloisi (2017:645) observe that this practice has resulted in workers being left out of workplace protections and in some instances, non-adherence to labour and taxation laws that apply to employees and employers.

The correct classification of “employee” or “independent contractor” has the benefits of obliging employers and independent contractors to comply with labour and taxation laws. Englebrecht and Dowis (2018:22) state that it promotes good relationships, helps the employer to abide by labour and tax laws, maintain employees’ records and make information readily available if required. Employers withhold payroll taxes from employees’ salaries as required by the Fourth Schedule of the Act and contribute to the Unemployment Insurance Fund (UIF) as required by the Unemployment Insurance Act 63 of 2001, and the Skills Development Levy (SDL) as required by the Skills Development Levies Act 9 of 1999. On the other hand, contract work provides great independence, and for many people, a greater perceived level of job security than traditional employment (Carlson, 2017:159). Independent contractors do not pay taxes on all income received as such; tax is only paid on net income (Le Roux, 2008:20) as they are allowed to deduct expenses from income received since it is not prohibited in terms of Section 23(m) of the Act as is the case with employees. As already mentioned, there is no withholding of taxes in the case of independent contractors (SARS, 2019).

Within the South-African tax fraternity, it is the responsibility of the employer to classify a person as an independent contractor or as an employee to be able to withhold tax on remuneration. The problem arises when the Department of Labour and SARS conduct an audit of the employer’s payroll and that of the independent contractor. Bruntz (1991:343) states that workers’ classification as independent contractors or employees continues to be a highly litigated area of taxation with significant tax consequences, should misclassification occur. Misclassification

occurs when workers are employed as contractors although they work in a way that is more indicative of an employment relationship (Cohen & Eimicke, 2013:20). If the employer is found to have an employee incorrectly classified as an independent contractor, SARS will calculate the back taxes owed, including interest and penalties, and require the employer to pay it over to SARS (SARS, 2019). Leberstein and Ruckelshause (2016:1) comment that the status of a worker as an independent contractor or employee remains a contentious topic in the world. In key industries, however, employee misclassification as independent contractor is prevalent.

1.1.1 Background

For labour-related and income and employees' tax purposes, as can be noted from below discussion, there are studies which attempted to address the issue of what defines an independent contractor or employee in South Africa. Most of these studies analyse the criteria used to classify independent contractors or employees and in some instances, their tax implications. A number of challenges have been identified in this literature because it is possible for the employer to manipulate the classification criteria of contractors and employees.

The misuse in this manner by an employer is done for a number of reasons: for example, the employer may not want a permanent employee in order to avoid employee costs or other employee legal obligations (Carlson, 2017:137). On the contrary, an employee may want to be able to deduct expenses from fees received rather than having to pay PAYE, SDL or UIF on fees and not be able to deduct any expenses in terms of Section 23(m) of the Act (Carlson, 2017:134). Misclassification may also possibly occur unintentionally from plain ignorance and incorrect interpretation. The ambiguity in these relationships causes the problem of misclassifying workers and can result in employment litigation (Englebrecht & Dowis, 2018:23). The very subjective and contentious nature of classifying an employee will be illustrated by considering some of the studies carried out on this issue.

Dann (1998) conducted a study analysing the tax implications of independent contractors and those of labour brokers. It was found that in the cases investigated, independent contractors functioned as labour brokers and provided employees rather than services. This issue seems to be a problem even internationally; for example, in the case of Internal Revenue Service and Microsoft (Gordon, 2019:56; Lovell et al., 2004). The implication from a South African income tax perspective is that the Fourth Schedule to the Act is then incorrectly applied to these taxpayers.

A study on employees, independent contractors and the theory of the firm was carried out by Carlson (2017). The aim of the study was to explore how firms decide whether to hire employees or contractors in the United States (US). It was found that when firms acquire workers, they often

do so in deceptive ways so that employer-employee relationships appear to be those between an employer and a contractor. Such devious practices are proved by the study of Kalleberg (2000) in the US on non-standard employment relations. The purpose of the study was to review the emerging research on irregular work arrangements and it was found that these were facilitated by inconsistent definitions, often inadequate measures, and a paucity of comparative research, making it possible for workers to be incorrectly classified.

Swartz and Ozoo (2016) compared employees and independent contractors in Botswana for the purpose of determining liability in violation of the law. It was found to be difficult in practice to distinguish between an employee and an independent contractor. The study also emphasised the importance of knowing whether a person is an employee or an independent contractor for the purposes of determining the rights and obligations to which they are entitled. Le Roux (2010) also explored the differences between employee and independent contractor in South Africa and found that it is difficult to be certain of the distinction based on the contract of employment, without considering other compelling circumstances.

Slater (2001) undertook a literature survey in South Africa to establish if a contract of employment and a contract of work with an independent contractor were indeed different. The findings in the study indicated the importance of ascertaining whether the relationship between the parties was that of employer-employee or employer-contractor. This distinction plays an important role with regard to the rights and obligations of each party, as determined in Swartz and Ozoo (2016). It was apparent that employers use the guise of the independent contractor to escape the obligations imposed on them by the various labour-related statutes.

The courts in South Africa have shown themselves to be willing to determine the true relationship between parties in an employment relationship. Court cases reveal the problematic nature of classifying an employee. For example, the following court cases show the processes the courts followed when determining the classification of independent contractors and employees. In SITA (PTY) Ltd v CCMA & Others (2008), the court provided guidance when assessing whether a person is an employee in circumstances where the definition of employee in Section 200A of the Labour Relations Act 66 of 1995 is not applicable. In SABC v McKenzie (1998), McKenzie was found by the court to be an independent contractor on the basis that he was not under the control of the SABC while earning a fee for each programme on a monthly basis because: he was not entitled to any employment benefit offered by the SABC to its employees; he was free to perform private work without the SABC's permission; and the granting of office space and access to a telephone and fax was a matter of convenience. His status as independent contractor was further validated by the fact that he was registered as an independent businessman with SARS.

Therefore, subjective criteria had to be applied in order to determine the true nature of the employment relationship.

In *SABC Ltd v CCMA & Others* (2009), it was found that an employee serves the will of the employer and follows orders imposed by the employer who is in charge of controlling and supervising the typical work to be carried out, including how it wishes such work to be executed. Conversely, it was furthermore decided in this case that a contractor is: hypothetically on an equal footing with the employer; has to produce in accordance with agreed terms and not necessarily by the employer's orders; and is free to decide when and how the job is to be executed, implying that there is no form of control or supervision by the employer. In this case therefore, other criteria were used to determine the actual nature of the employment.

The judgement in *Niselow v Liberty Life Association of Africa Ltd* (1998) was delivered to reinforce the notion that the purpose of the contract has to be established and not necessarily how the contract is branded. In *SATDU v Ebrahim's Taxis* (1998), the arbitrator found that the drivers were in fact employees owing to the degree of supervision and control exercised by the employer.

It should be noted that the literature identified above is highly relevant to this study and it should further be noted that most decisions on classifications were carried out through the court process in South Africa (Slater, 2001). In light of the above literature, it is apparent that the research attempted to address the issue of who is likely to be classified as an independent contractor. However, these studies did not extend to suggesting/recommending how the classification of independent contractors could be simplified and made in more accurate manner for tax purposes. This study will explore if there is a more simplified system which could be used when deciding on the status of an independent contractor or an employee for income tax purposes. Also, the scope of the existing studies did not extend to practices abroad for the purposes of comparison. This study investigates if there is a sophisticated method used by selected developed countries when determining the status of independent contractors for income tax purposes. According to Heyneman (1980:403), a developed country is "a sovereign state that has a high quality of life, developed economy and advanced technological infrastructure relative to other less industrialized nations".

Developed countries are preferred in this study as opposed to developing countries. Developed are normally regarded as countries with a modern tax system with high capacity for collection due to strict tax compliance initiatives and redistribution in when compared to developing countries (Melanie, 2021). In most developed countries, the tax system is simplified and accorded citizens with less hassle tax compliance (InvestinEstonia, 2020). According to Tonzi and Zee (2001), developing countries encounter challenges when they attempt to establish efficient tax systems

when compared to developed countries as most workers in these countries are typically employed in small informal enterprises or in an agricultural sector where employment is not regulated. The base for an income tax is therefore is hard to calculate as most workers are seldom paid a regular fixed wage, their earnings fluctuate, and many are paid in cash (Leibbrandt et al., 2016). For above mentioned reasons, this study considers the comparison with developed countries appropriate due to their sophistication of their tax systems.

1.1.2 Motivation of the topic

The Fourth Schedule to the Act provides for a special exclusion of payments made to independent contractors from the definition of “remuneration”. However, there is no definition of “independent contractor” in the Act. SARS has implemented IN17 in this regard.

In deciding whether an independent contractor is an employee for taxation purposes, the criteria stipulated in the IN17 are used as guidelines. The procedure to be followed is to apply a statutory test and then the common law dominant impression test. The problem with these tests is that they are open to misclassification due to the subjectivity involved as they are interpretative in nature and conclusions are subject to debate (SARS, 2019:3). Misclassifying an employee as an independent contractor may result in, for example, non-levying of employees’ tax such as PAYE, UIF, and SDL, as independent contractors are not liable for these taxes; or the employer may be able to avoid employee costs such as fringe benefits or the administration of tax on remuneration that is payable to SARS (SARS, 2019:4).

The procedures of developed countries such as Australia and Germany when determining whether or not an independent contractor is an employee could perhaps be of assistance in developing a better system in South Africa. In respect of relevance, Australia and Germany have been selected for this study as they are both developed countries while South Africa is a developing country. Australia and Germany are selected for this study as developed countries have well established tax systems in comparison with developing countries (Melanie, 2021).

There are commonalities among these countries which result in comparisons to be appropriate for the purpose of this study. South African tax law is based on English income tax legislation (Croome, 2013:6; Schreiner, 1967:11). Schreiner (1967:11) states that South African judges use English case law where a case is ambiguous or untested. It is recognised that Australia, together with other international countries such as Germany, has played a significant role in providing guidelines for law-related cases. This has been supported in the Katz Commission’s Fifth Interim Report (Katz Commission, 1997:56). For example, when introducing a particular anti-avoidance measure; in this case an independent contractor anti-avoidance rule, reference is made to

guidelines in Australian legislation (Katz Commission, 1997:56). The Australian and German legal systems are both influenced by English law (LawTeacher, 2022; Pienaar, 2012:154). Certain aspects of the South African Constitution are substantially based on the Australia and German Constitution (Davis, 2003:187; Perry, 2014).

In South Africa, Australia and Germany; a taxpayer is obliged to a fair share of the tax burden regardless of whether the law is determined by the Constitution or legislature (Moosa, 2015:24). The Oxford Dictionaries refers to a Constitution as 'a body of fundamental principles or established precedents according to which a State or any other organization is acknowledged to be governed', and legislation is referred to as 'the process of making laws'. In Australia and Germany, the interpretation is a question of law in the determination of the legislature's intention even if the meaning is not compatible with human rights (Moosa, 2015:24). This is contrary to South Africa where constitutional supremacy prevails and Parliament's will does not play any meaningful role in statutory interpretation.

Following are further issues resulting in comparison appropriate: South Africa and Australia excluding Germany are both members of the Commonwealth Group (Commonwealth Network, 2020). The Commonwealth Group is a group of nations that support and work with one another in meeting international objectives (Commonwealth Network, 2020). Countries who are members of the Commonwealth Group typically have common culture, heritage in language, education, law and democratic tradition culture (Commonwealth Network, 2020). The Australian Tax Office (ATO) aims to resolve tax disputes efficiently and effectively and subject to scrutiny (ATO, 2017). The draft to Tax Administration Bill was informed by international best practices and a comparative evaluation with tax administration laws over long periods, such as Australia (Memorandum on the Objects of the Tax Administration Bill, 2011:179). Germany is one of South Africa's most important trading partner, like Australia, they both have international tax treaties with South Africa (German Mission, 2022)

From the above, it appears appropriate to compare the criteria used in these countries for the classification of an employee and an independent contractor for tax purposes. The procedure to be followed in this study is to investigate the classification criteria applied in determining the status of independent contractors for income tax purposes in South Africa, and then compare these to the methods applied in Australia and Germany. From an income tax perspective, this study is worthwhile as it will determine if there is a well-refined basis of classifying employees and independent contractors for tax purposes among these countries. Once determined, its application will result in reducing a risk of misclassification, avoidance of undue taxes, fines and penalties.

1.2 Problem statement

Fees paid to independent contractors are not subject to withholding taxes such as PAYE, SDL and UIF. Business expenses may be deducted by independent contractors themselves from income, for income tax purposes. This privilege is not available in the case of employees: instead, an employer incurs additional costs such as employee benefits and has to comply with other legal obligations in the Basic Conditions of Employment Act 75 of 1997 (BCEA) and Labour Relations Act 66 of 1995 (LRA). It could therefore be tempting for employers and independent contractors to perceive employees as independent contractors. This is because the tax system in South Africa has open-ended classification criteria when determining the status of an independent contractor for income tax purposes. The problem is that these classification criteria are subject to possible manipulation or misuse by an employer. The manipulation or misuse may occur due to the subjectivity involved when making decisions about classification. Misclassification may be done intentionally for the benefit of the employer or employee, or through incorrect interpretation.

The existing literature does not extend to recommending how the classification of independent contractors for tax purposes could be clarified. This study attempts to answer the research question by comparing the criteria in IN17 with the methods used in Australia and Germany in an attempt to establish a simpler and more accurate method of worker classification that would leave less room for uncertainty, manipulation or misinterpretation.

1.3 Research objectives

The following research objectives were formulated to address the research question:

1.3.1 Main objective

The main objective of this study is to establish if there is a more simplified and accurate criteria used to classify an employee and an independent contractor for tax purposes. This is achieved by comparing criteria used in South Africa (in its current form) with those of Australia and Germany. The question to be addressed in this research is whether there is a more sophisticated method to classify an employee and an independent contractor.

1.3.2 Secondary objective

To achieve the main objective the following secondary objectives are formulated:

- (i) To describe and analyse the classification criteria applied in South Africa when determining the taxation status of independent contractors (that is, to be classified as an

independent contractor or taxed as an employee) as envisaged by the Act read with IN17 (refer to Chapter Two).

- (ii) To describe and analyse the classification criteria used by Australia and Germany in determining the taxation status of independent contractors and that of employees. As part of the analysis, the manner in which independent contractors and employees are taxed in their respective countries is considered (refer to Chapter Three).
- (iii) To compare the classification criteria identified, provide summary, conclusions and recommendations on the findings of the study (refer to Chapter Four).

1.4 Research design/method

The research was conducted as follows:

1.4.1 Study context and paradigmatic assumptions

Johnson and Christensen (2012:31) state that a paradigm is an approach to research or to doing research. Research designs are either classified as qualitative, quantitative or mixed method. According to Daniel (2016:91), qualitative and quantitative research methods lie on the same continuum as they all aim at identifying research problems using a different approach. Bryman (2008: 22-23) maintains that the differences between qualitative and quantitative research are that their paradigmatic approach regarding their epistemological (ways of knowing and questioning nature of reality) and ontological (what is to be known and suppositions about the nature of authenticity) assumptions.

Apuke (2017:41) describes quantitative research as a method of quantifying and analysing variables in order to get results. It involves the utilisation and analysis of numerical data using specific statistical techniques to answer questions like who, how much, what, where, when, how many, and how. Wahyuni (2021:75) states that qualitative research is generally applied in the first stage of the research and aims at displaying a recent state of events. Analysing data by qualitative research essentially involves dismantling, reassembling and segmenting data to formulate meaningful outcomes to draw inferences.

The approach in this study is qualitative in nature and has been adopted as it employs all the necessary instruments (meanings, concepts, definitions, metaphors, symbols and descriptions of things) that can evoke recall which aids problem-solving (Berg & Howard, 2012; Daniel, 2016:92). The use of a rigorous qualitative research method can also enhance the development of quality measures, the development and dissemination of comparative quality reports, as well as quality improvement efforts. The approach followed in this research is a systematic literature review. A

systematic literature review follows a clearly defined protocol or plan where the criteria is clearly stated before the review is conducted (Okoli & Schabram, 2010:37).

1.4.2 Ontological assumptions

Ontology is the study of 'being' and is concerned with 'what is', i.e., the nature of existence and structure of reality as such (Crotty, 1998) or what it is possible to know about the world (Snape & Spencer, 2003). The SAGE Online Dictionary of Social Research Methods (2006) defines ontology as "a concept concerned with the existence of, and relationship between, different aspects of society such as social actors, cultural norms and social structures.... Ontological issues are concerned with questions pertaining to the kinds of things that exist within society". For Richards (2003) ontology entails the assumptions we make about the kind and nature of reality and what exists. Snape and Spencer (2003) also define ontology as the nature of the world and what we can know about it. It is held that in ontological orientation, qualitative researchers are interpretivists in terms of their strategies (Daniel, 2016:92).

This study is interpretative in nature in that the goal of the researcher operating within this paradigm is to decipher non-empirical patterns or regularities (Olalere, 2011: 29-30).

1.4.3 Epistemological assumptions

According to Richards (2003) and Snape and Spencer (2003), epistemology generally refers to assumptions regarding the kind or nature of knowledge or how it is possible to find about how the world works. Crotty (1998) regards epistemology as the way we observe the world and make sense of it. It comprises knowledge and embodies an understanding as to what that knowledge involves. Crotty (1998) further states that epistemology is about what is possible, and what can or cannot be attempted. Bryman (2008:13) defines epistemology as "an issue [which] concerns the question of what is (or should be) regarded as acceptable knowledge in a discipline". To further explain the meaning of epistemology, Cohen et al. (2007:7) state that epistemology is about the assumptions which one makes about "the very bases of knowledge – its nature and form, how it can be acquired and how communicated to other human beings". To sum up, in epistemological orientation, qualitative researchers are subjectivists (knowledge is merely subjective and that there is no external or objective truth) and anti-positivists (social realm may not be subject to the same methods of investigation as the natural world) in their approach (Creswell, 2009:4-17).

This study was conducted with a subjectivist and anti-positivist approach. The origins of South African tax legislation read with IN17 in its current form regarding the taxation status of independent contractors are considered and the study will also evaluate how such legislation and

guidelines have developed. The study also contains an international comparison between South African legislation together with its relevant guidelines. This will then be compared with guidelines used in Australia and Germany to review whether South Africa's tax legislation and its guidelines are in line with those of said countries. This further illustrates the qualitative nature of this study.

1.4.4 Methodological assumptions

According to Gaffikin (1989:2), "methodology is usually taken to be a discipline bordering on philosophy, whose function is to examine the methods which are used or should be used to produce valid knowledge."

The point of departure for this study is the need to determine the status of independent contractors for income tax purposes. This was followed by a discussion of the income tax regime governing independent contractors and employees in its current form. The development of the legislation and the proposed amendments is discussed by studying the relevant independent contractor's provisions in the Act and considering notable changes that have been made to such provisions since their inception. In support of this method, a non-empirical study by Van Wyk, and Dippenaar (2016:2) was conducted where existing literature is investigated by performing a historical analysis within a South African context in order to address the research problem identified. Another study carried out by Van Wyk (2011:3) investigated tax implications for South African employees working abroad in relation to the effect of change in tax legislation.

The second part of the discussion outlined above is the critical analysis of IN17 (Issue 5) which was issued on the 5 March 2019. In this part, the basis for implementing IN17 is considered. This is followed by discussion of the procedure followed when determining whether or not an independent contractor is an employee for tax purposes. At this point, each classification criterion is critically analysed for any possible misinterpretation which could potentially influence the final conclusion.

As an attempt to establish more simple and accurate classification criteria of an employee and an independent contractor, this study compares criteria used in South Africa with those used in Australia and Germany when determining the taxation status of independent contractors. Australia and Germany are both developed countries. Developed countries have modern tax systems with high capacity for collection and redistribution in contrast with developing countries (Melanie, 2021).

In determining the classification of an employee and an independent contractor in Australia and Germany for the purposes of this study, reference is often made to their respective L&E Global handbooks (L&E Global). L&E Global is an alliance of employers' counsel worldwide. It is the

worldwide leader for cross-border labour and employment law services across six continents. The purpose of a number of firms of L&E Global is to assist their clients with practical guidance, essentially to achieve their objectives in any part of the world. Their members work closely with the legal, human resource divisions, corporate, and various other sectors to guide the strategic issues which may arise at places of work (L&E Global, 2017).

The articles in L&E Global provide a thorough outline of the law, rules, appropriate structures and trends affecting employment and independent contractors' arrangements. For the purposes of this study, the discussion will be based on the following parts of the handbook: Part II, dealing with the legal framework regulating contract and employment arrangements; Part III, dealing with the practical aspects of re-classification and its associated legal risks and exposures; and Part IV, dealing with the appropriate structures and methods of structuring independent contracting arrangements.

The approach outlined above concurs with methodologies applied in legal research of Langbroek et al. (2017:2). According to Langbroek et al. (2017:2), a legal research is usually done by referring to academic publications, scholarly comments, case law and legislation, and by referring to the outcome of studies in other disciplines. The findings are then used by researchers to analyse, organise and present the information to influence judges, practitioners, legislators or subordinates to understand their lines of thought (Langbroek et al., 2017: 2).

1.4.5 Theoretical framework and assumptions

For the purposes of this study, it is assumed that income tax legislation follows the principle of the essential form of good taxation. Van Oord (2015:31) terms the essential form of good taxation as the "canons of taxation" which refers to tax legislation that is economical, equitable, certain and convenient (Van Oord, 2015:31).

The study considers methods of improving the manner in which independent contractors are classified for tax purposes in South Africa. The assumption is that the collection of taxes on remuneration of employees and on net income of independent contractors will contribute to the national revenue fund. According to Black et al. (2008:120) and Van Oord (2015:31), these taxes must adequately contribute to the fiscus without distorting production and consumption. According to Nel and Viviers (2015:158), to be certain of the amount of tax payable, the timing of payment and the payment method should be clear and consistent.

Van Oord (2015:31) states that for these taxes to be reasonable, the capability, based on income of employees and independent contractors to settle their tax liability, has to be considered; the ability to pay test should apply across various taxpayers and not only employees or contractors

(Black et al., 2008:122). Simplified classification methods are more convenient and encourage compliance of employers and independent contractors. Administration is also simpler and more efficient which is important to a successful tax policy (Van Oord, 2015:31).

1.4.6 Literature review

In Paul and Criado (2020:1) it is held that a literature review article provides a broad outline of literature related to a method/theme/theory and refers to prior studies to strengthen the foundation of knowledge. Maggio et al. (2016:297) state that a literature review is a synthetic review and summary of what is known and unknown regarding the topic of a scholarly body of work, including the current work's place within the context of existing knowledge. The literature review basically entails establishing what has been said about the topic in the past (Hutchison & Duncan, 2012:112-114). To achieve this, the current research literature should be critically analysed.

A literature review is conducted in support of the critical analysis of legal research. This study is non-empirical in nature and reliance derives from theoretical sources instead of numerical data. Secondary data, which are available from other sources without any particular method of collection, are used in the study. Academic literature, legislation, court cases, books and previous publications, among others, are consulted as sources of information and analysed during the study.

1.4.7 Limitation of the study

The study was carried out in a South African context. The focal point is to determine a more simplified and accurate classification criteria for an employee and an independent contractor for income tax purposes in South Africa. The study does not extend to the analysis of income tax legislation of Australia and Germany. The study focused on classification of independent contractors and employees for tax purposes across industries. This study does not extend to the status of employees and independent contractors in terms of the BCE Act and LR Act. Furthermore, the study does not cover the following categories of "employees" as defined in paragraph 1 of the Fourth Schedule of the Act:

- Any person who receives any remuneration or to whom any remuneration accrues by reason of any services rendered by such person to or on behalf of a labour broker
- Any labour broker
- Any person or class or category of person whom the Minister of Finance by notice in the Gazette declares to be an employee for the purposes of the definition of employee
- Any personal service provider.

Furthermore, for the purposes of this study, it is assumed that the person is carrying on a trade and this fact will not be discussed.

1.5 Chapter overview

Chapter 1: Introduction

This chapter is the starting point of the study and provides the reader with the introduction and background relevant to the classification of independent contractors and employees. This chapter considers the motivation of the study and presents the problem statement; an outline of the relevant research objectives aimed at addressing the problem statement; and an overview of the research methods to be used.

Chapter 2: Taxation of independent contractors and employees in South Africa

This chapter considers the classification criteria applied in South Africa when determining the taxation status of independent contractors as envisaged by the Fourth Schedule to South African Income Tax Act 58 of 1962 and the IN17.

Chapter 3: Taxation of independent contractors and employees in the context of selected developed countries

In this chapter, the classification criteria used by Australia and Germany in determining the taxation status of independent contractors and that of employees are described. The chapter also covers the manner in which independent contractors and employees are taxed in these countries.

Chapter 4: Summary, conclusion and recommendations

This chapter serves as the executive summary and contains the comparison of the classification criteria and provide conclusion and recommendations. This chapter also identifies areas in which the South African independent contractors' legislation may be lacking and makes suggestions for improvements.

CHAPTER 2 TAXATION OF INDEPENDENT CONTRACTORS AND EMPLOYEES IN SOUTH AFRICA

2.1 Introduction

The main source of the government's income is income tax which is levied under the Act on the taxable income of persons such as natural persons, trusts and companies (Cohen & Eimicke, 2013:12; SARS, 2017:5). In this study, income tax on the remuneration paid by employers to employees and the fees paid to any person considered to be an independent contractor is considered. Income tax on remuneration, or employees' tax as it is referred to, is governed by the Fourth Schedule to the Act. Part II of the Fourth Schedule to the Act specifically deals with whether an amount of tax on remuneration paid should be withheld by employers under contract of employment with employees or those considered to be independent contractors.

The term "independent contractor" is not defined in the Act. To overcome this problem, SARS implemented IN17, a guideline to assist in determining what constitutes an independent contractor (SARS, 2019). It is important to determine if a person is appropriately classified as an independent contractor, as this will have an impact on whether or not an employer should withhold employees' tax.

Currently, the tax system in South Africa has open-ended classification criteria when determining the status of an independent contractor for employees' tax purposes. This study will attempt to establish if there is a simplified classification procedure for independent contractors. This chapter considers the classification criteria applied in South Africa when determining the taxation status of independent contractors as envisaged by the Fourth Schedule to the Act and the IN17, and addresses the secondary objective, as identified in par 1.3.2 (i).

2.2 Background information

An employee under contract of employment is entitled to remuneration which is subject to employees' tax in terms of Part II of the Fourth Schedule to the Act. In contrast, independent contractors are not subject to employees' tax, but have to pay income tax independently from the employer (SARS, 2019). Independent contractors are entitled to a deduction of business expenses from fees received from an employer (Le Roux, 2008:20). The deduction results in a reduced tax liability for independent contractor. They will pay less tax on income received and be less burdened by other employees' legislative compliance. This privilege of deducting business expenses is not available in the case of an employee because it is prohibited in terms of Section

23(m) of the Act. An employer will also have to incur additional costs, such as employee benefits and has to comply with other legal obligations in the BCE Act and LR Act.

In some ways it is thus more advantageous, from a tax perspective, to be classified as an independent contractor as opposed to an employee (Eberhard et al. 2017:48). Eberhard et al. (2017:48) also found that more workers under a traditional contract of employment were becoming engaged in employment as independent contractors because they were excluded from withholding taxes and were allowed to deduct qualifying business expenses themselves from income generated when calculating their taxable income.

This has resulted in an attempt by some independent contractors to avoid being classified as employees, or employers intentionally classifying employees as independent contractors. This is the issue the study attempts to address in order to ensure more accurate classification. The current legislation in the Act will be critically analysed to see what it determines regarding the employers' tax on employees and independent contractors.

2.3 Income tax legislation

The Fourth Schedule of the Act deals with amounts to be deducted or withheld by employers "from remuneration paid to an employee. The definitions of "employer", "employee" and "remuneration" are contained in paragraph 1 of Part I of the Fourth Schedule to the Act.

Paragraph 1 states that the term employer means "any person who pays or is liable to pay to any person any amount by way of remuneration..." (emphasis added).

The term employer therefore generally includes any person paying remuneration to an employee in return for services rendered.

The term employee means "(a) any person (other than a company) who receives any remuneration or to whom any remuneration accrues; (b)..." (emphasis added).

In contrast, employee refers to any person receiving remuneration from an employer. This holds that to be identified as an employee in terms of the South African tax law, a worker must either work for another person and in return receive payment in the form of remuneration; or assist another person in carrying out or conducting that person's business (Fourie, 2008: 184). Fourie's definition (2008) extends the usual definition of employee under common law.

The term remuneration is defined as "any 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 or

stipend, whether in cash or otherwise and whether or not in respect of services rendered...” (Par 1, Fourth Schedule of the Act).

Remuneration is therefore an amount received by or accrued to an employee during a year of assessment. The amount is payable by an employer whether it is for services rendered and subject to be taxed by SARS over the period during which it is received or accrued (SARS, 2017:9). It is therefore important to notice that the term “remuneration” is a critical factor when the decision has to be made regarding whether or not an employer must withhold employees’ tax to be paid to SARS within the prescribed period of seven days.

Subparagraph (ii) of the definition of “remuneration” specifically excludes certain amounts from the definition of remuneration. Subparagraph (ii) states that:

“(i)..., (ii) any amount paid or payable in respect of services rendered or to be rendered by any person 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...” (emphasis added).

Therefore from the above, it is evident that any person, who in the course of any trade carried out, may be classified as an independent contractor (SARS, 2019:3). There is no more detailed definition of independent contractor in the Act. The only determining factor in the Act is when the amount paid does not constitute remuneration in terms of exclusionary subparagraph (ii) of the definition of “remuneration”. Once the exclusionary paragraph applies, the amount paid will not be subject to employee’s tax.

Furthermore, subparagraph (ii) contains two provisos determining whether a trade is being carried out independently, referred to as the statutory test. IN17 was introduced to assist in determining what an independent contractor is. In terms of IN17, it is only by these so-called “statutory test” (often referred to as the premises-test and control-test) that one comes to know indirectly what an independent contractor is (SARS, 2019). This is followed by the common law dominant impression test application in cases where the payer for the services rendered is a different person from the one to whom the service was rendered.

A discussion on the application of the statutory test follows, after which the common law dominant impression test in terms of IN17 is discussed.

2.4 The statutory test

The statutory test are applied in terms of the two provisos to subparagraph (ii) of the definition of “remuneration” in the Act. In terms of the Act, as indicated above, the amount paid to any person is not remuneration (not subject to employees’ tax) if the person is “carrying on a trade” independently of the payer and any person to whom service is rendered. The term “trade” is defined in very wide terms in the Act and includes the terms “business” and “venture”.

The expression “carrying on a trade” is not defined in the Act. In the context of this study, whether a person is carrying on a trade is a matter of fact and it is assumed that whatever services the person is rendering, a trade is being practised. Therefore, carrying on a trade independently will refer to “carrying on a trade in the absence of undue influence and bias...” (SARS, 2017:2).

2.4.1 Application of statutory test

The statutory test consist of two separate tests, (proviso (i) and (ii) of the definition of “remuneration”) being the first test, referred to as the premises and control or supervision test. The second test refers to the number of employees that a person employs. These tests are discussed below.

2.4.1.1 The first test

The first test is a proviso stating that a person shall not be deemed to be carrying on a trade independently if both parts of the test are met. The two parts of this first test are referred to as first the premises-test and second, the control and supervision- test.

In the first part of this test, a person shall not be deemed to carry on a trade independently if the services are required to be performed mainly at the premises (premises-test) of the person by whom such amount is paid or payable or of the person to whom such services were or are to be rendered (proviso (i) of the definition of remuneration).

Under the premises-test, the landmark case for this requirement is that of *Sekretaris van Binnelandse Inkomste v Lourens Erasmus* (1966) where it was held that “*mainly in this context means a quantitative measure of more than fifty percent*”. In terms of the law, the one who pays for the work might be different from the person for whom the work was carried out. The requirement is that the person rendering the services must be independent of both parties in order to fall outside the employees’ tax net (Cohen & Eimicke, 2013:3; SARS, 2019:5). In instances where a person receives a payment from a person to whom the services were rendered, the application of the statutory test is straightforward. However, if the payment is made by a different person, it could be difficult to apply a statutory test. In this instance, the so- called “common law

dominant impression test”, as further developed by the South African Courts, are applied (Carby-Hall (2002:10). The common law dominant impression test is discussed below.

In the second part of this test, a person is not considered to be carrying out a trade independently if that person is subject to control or supervision (control or supervision-test) of any person regarding how the work is to be performed or determine the time to be spent on the work (proviso (i) of the definition of remuneration). The IN17 clarifies this proviso by stating that:

“[T]his control-or-supervision part of this test refers to “any” person. This is wide, and could include the payer of the amount, the recipient of the service or any other person who has a contractual right to control or supervise the person in respect of those specific services” (SARS, 2019:8).

According to the Lawnsider dictionary (2021), “control and supervision” means “*establishing the nature of, directing and guiding the preparation of, and approving the work product and accepting responsibility for the work product, as evidenced by time directly spent on supervising the work to ensure that the person working is familiar with the significant details of the work*”.

This concludes that, according to the first test, if the “premises” and “control or supervision” tests are satisfied then a person is not deemed to be carrying on trade independently (SARS, 2017:2). Therefore both parts of the tests need to be satisfied for this to be true and in that case the amount received would constitute remuneration and be subject to withholding tax from the employee.

2.4.1.2 The second test

In terms of the second proviso to subparagraph (ii), if a person employs three or more people on a full-time basis through the particular year of assessment, such person is deemed to be carrying out a trade independently. The exception to this rule occurs when the person employed is connected to the employer. This test is the overriding test in subparagraph (ii) of the exclusions from remuneration. The test takes primacy over the first test regardless of requirements of the first test being met, including the common law position (SARS, 2017:8).

As can be deduced from the above discussion, establishing that a person is an independent contractor requires a significant amount of judgement, and considerable care should be taken to ensure that correct classification is achieved. As stated in the preceding discussion, further complications for classification of independent contractor arise if the service is rendered to one person and payments for the service rendered are made by a different person. In this case, to minimise the risk of misclassification, the common law dominant impression test would be applied. This is discussed below, as it is envisaged in IN17.

2.5 The common law test

As discussed above, the common law dominant impression test is applied if services are rendered to a person who is not liable to make a payment in return (Carby-Hall, 2002:10). The current South African common law position in this situation is that the so-called “multiple or dominant impression test” (the test) must be applied to determine whether a person is an independent contractor or a standard employee (Fourie, 2008:115; Mamabolo, 2011:16; Mokofe, 2018:35;). In common law, multiple indicators are applied when testing the status of a person, whether independent contractor or employee, as decisions on the status of the relationship cannot be based on a single indicator. The common law test was established to serve as a guide to characterise employees and contractors in the workplace. The test is applicable to a natural person or an organisation.

2.5.1 Application of the dominant impression test in South Africa

According to Makofe (2018:35) and Swartz and Ozoo (2016:9), it is difficult to determine whether the contract between a non-standard worker with the employer is a contract of service (employment/servant) or contract of work (independent contractor). A non-standard worker is often described as ‘atypical’ or even ‘marginal’ and are those workers who work, for example, as contract-workers, fixed-term-workers, part-time-workers, seasonal-workers and include those workers supplied by employment agencies (Fourie, 2008:111).

It is in marginal cases where the dominant impression test’s merit is considered by the South African courts (Slabbert & Pienaar, 2013:101; Slater, 2001:4). The dominant impression test suggests that it is necessary to evaluate all aspects of the contract and the relationship and then make a classification based on the “dominant impression” formed in that evaluation (Swartz & Ozoo, 2016:4; Slater, 2001:33).

In the *Ongevalle Kommissaris v Onderlinge Versekerings-genootskap AVBOB* (1976) case it is stated that in instances where the relationship evidences the characteristics of both employee and a contractor, criteria used in the test will be applied to establish which criteria provide the “dominant impression” in favour of either an employee or a contractor. The court in this case states that the words “daarvolgens werk” (working according to that) in the Afrikaans version of Section 3 (1) of the Workmen’s Compensation Act obviously mean “volgens ‘n dienskontrak werk,” (work according to contract of service) and as such, the nature of the contract must be established for each specific case. The contract might be written or verbal and should be scrutinised for facts or surrounding facts. This is found in Joubert JA’s judgement in the case of *Smit v Workmen's Compensation Commissioner* (1979) where it was concluded that all factors in

the agreement must be considered and that the procedure is to categorise all existing factors, group and weigh them to establish a strong group in favour of either an employee or a contractor.

A landmark court case of the dominant impression test is that of *Colonial Mutual Life Assurance Society Ltd v MacDonald* (1931) and *Smit v Workmen's Compensation Commissioner* (1979). In these cases, it was found that if indicators are supported by proof, then they will play a crucial role in the process of deciding whether the nature of the contract is that of employment or contractor. The procedure followed by the courts is to weigh these indicators before deciding whether the dominant impression of the worker is that of an employee or a contractor (Swartz & Ozoo, 2016:9). SARS IN17 broadly categorises these indicators into the following groups:

- (i) Near-conclusive indicators of the acquisition of productive capacity (of employee status or non-independent business status)
- (ii) Persuasive indicators of the acquisition of productive capacity (of employee status or non-independent business status) and
- (iii) Indicators resonant (creating an immediate or superficial impression of) of an employee relationship or an independent contractor relationship (SARS, 2019:9). The test consists of a non-exhaustive list of common indicators summarised in Annexure B of IN17 as the Common Law Dominant Impression Test Grid.

The above-mentioned indicators/weightings are designed to guide auditors, employers, employees, contractors or any party interested in determining whether the relationship is that of an employee or a contractor. This will assist employers specifically as to when to withhold employees' tax.

In terms of the IN17, the guide provided is to apply the grid to analyse the relationship. The indicators are applied on a case-by-case basis considering the nature of the business, industry, customer, workers and business operations.

A brief summary of the indicators (based on categories) giving rise to an employer and independent contractor relationship follows. According to *Colonial Mutual Life Assurance Society Ltd v MacDonald* (1931) and *Smit v Workmen's Compensation Commissioner* (1979), a record of these indicators has an impact in the decision made by SARS as to whether the agreement entered into is that of an employee or an independent contractor.

2.5.1.1 Near-conclusive indicators of the acquisition of productive capacity (of employee status or non-independent business status)

These indicators focus on the quality of control (the extent to which the employer is involved in the activities of a worker while rendering the service). These indicators are set out below.

- **Control of manner**

The employer controls the manner in which the work is done either by detailed instructions, by training, by requesting that approval be obtained at any stage of rendering the service, or by establishing disciplinary steps for undue performance by the worker. This entails control as to which tools, subordinates, materials or technology are required. If this control exists, an employee's productive capacity is acquired and this results in the indicator of an employer-employee relationship (SARS, 2019:11). Conversely, the absence of this control is an indicator of an independent contractor relationship.

The manner in which the person works is subject to the control or direction of another person. According to Worklaw (2021), control is present once a worker obeys instructions from his/her employer or his subordinates as to how the work should be carried out. This usually occurs in an employment relationship. If the work is to complete a certain task and the worker determines how to complete it, then control is not present. This is usually the case in employer-contractor relationships (Van Schalkwyk & Nel, 2013: 414).

- **Payment regime**

If payment is made and no material reference is made to a specified result, this could indicate employee status. This is because the worker is then being paid for effort rather than results (SARS, 2019:11). However, results are expected in any employment relationship. IN17 provides clarity by stating that if there is no financial sanction when results are not achieved, the result could be in favour of an employee relationship (SARS, 2019:11). Payment at regular intervals without reference to results (output) and payment by time-periods are both indicators of an employee relationship.

On the contrary, if the purpose of employment is to carry out a particular job or produce certain results (*Smit v Workmen's Compensation Commissioner*, 1979), the resultant relationship is that of an employer and independent contractor.

- **Person who must render the service**

The existence of a contract of employment implies that the employee is obliged to serve his/her employer. Therefore, the employer may insist on personal services and reject substitution. The

fact that an employer is not allowed to make a substitution implies that an employment relationship is prevalent (SARS, 2019:12).

In Themis (2005), it is held that an employee has to serve the employer in accordance with the contract of service at all times. On the other hand, an independent contractor is free to make a substitution or work for others as and when required (Themis, 2005).

- **Nature of obligation to work**

This arises if it is compulsory to work on a full-time basis and it is therefore an indicator of employee status as the exclusive acquisition of the worker's productive hours or capacity has occurred (SARS, 2019:12). In the case of an employer and an independent contractor relationship, an employer is interested in the results of a specific task and not the time consumed in producing those results. This means that being present at work irrespective of whether the work is available or not, indicates an employer-employee relationship (SARS, 2019:12).

The existence of an obligation to be present and available to work, regardless of whether work is available, indicates that the acquisition of productive capacity was the employer's foremost consideration, an indication of an employee relationship (Workinfo, 2021).

- **Employer (client) base**

If a worker is not, according to the employment contract, allowed to serve other clients, this amounts to acquisition of the exclusive use of the worker's productive capacity and gives rise to the existence of an employer-employee relationship (SARS, 2019:12). An independent contractor has multiple sources of income as they are not limited to any single place of employment. An employee is therefore restricted in developing a client base, and typically does not have one (SARS, 2019:12).

Erasmus (2006) states that in this case, the indicators characterising a true independent contractor are usually considered by the courts. An independent contractor is characterised by having established an entity with one or more clients and making a profit or loss. On the other hand, an employee is characterised by being totally dependent on the employer (Erasmus, 2006).

- **Risk, profit and loss**

Risk related to an employer's profitability or solvency is generally not relevant in the case of an employer-employee relationship (SARS, 2019:13). This means that an employee is not affected by such factors. However, this is not the case for independent contractors as they are exposed to any commercial risks, profits or losses which may affect their business. These indicate independence or non-exclusive acquisition of productive capacity. (SARS, 2019:13).

This means that an employee is not obliged to share losses, should the business of the employer crash, and is unlikely to invest money in such a business while an independent contractor invests in his business for its survival (Erasmus, 2006).

Based on the preceding discussion, this category of indicators carries more weight when compared to the categories to be discussed below according to IN17. This is the case as the decision is centred around the acquisition of the worker's productive capacity in the case of an employee and the results, in the case of an independent contractor.

2.5.1.2 Persuasive indicators of the acquisition of productive capacity

The indicators in this category point to the degree or extent of control. They also indicate what the purpose was for acquiring control. These indicators tend to indicate the existence of an employee, depending on the circumstances and are persuasive because of their relationship to the extent of control. Control enables management to convert productive capacity into productive activity (SARS 2019:13). Some examples are discussed below.

- **Instructions or supervision**

An employer-employee relationship is evidenced when the employer controls the work done and the environment in which the work is done. This is indicated when the employer gives instructions as to the location, when to begin or stop, the pace, order or sequence of work and an employee is expected to obey these requirements. Supervision takes place typically in most workplaces or employment relationships. A significant degree of supervision is a strong indicator in favour of employee status (SARS, 2019:13). The independent contractor, however, is hypothetically on an equal footing with the employer and is expected to produce in terms of his contract terms and not by the orders of the employer (*SABC v McKenzie*, 1998; SARS, 2019:13).

- **Report**

The presence of a reporting regime is evidence of supervision. The existence of a reporting regime depending on factors such as content, detail, regularity, and obligation can be persuasive in favour of an employer-employee relationship (SARS, 2019:14).

A reporting regime which controls the manner that work is done indicates an employer-employee relationship as it satisfies the "control" requirement in exclusionary subparagraph (ii) of the definition of "remuneration" in the Fourth Schedule of the Act (Workinfo, 2021).

- **Training**

The provision of training for an employee by an employer in connection with the employer's method or systems is usually a strong indicator of an employer-employee relationship. This is because provision of training contains an element of control as the aim is to improve productivity.

Training relates to quality of control and is sufficient to satisfy the control requirement in exclusionary subparagraph (ii) of the definition of “remuneration” in the Fourth Schedule of the Act (SARS, 2019:15). In contrast, contractors provide their own training and choose their own production methods. (SARS, 2019:15).

According to Workinfo (2021), the above is substantiated in instances where training is provided by the employer to a person in respect of the employer’s operational methods, indicating the acquisition of productive capacity which is in line with the employment relationship. A contractor makes provision for training for himself in ensuring that the client’s expectations are achieved.

- **Productive time (control of working hours, the working week)**

Where a worker has no rights over controlling his or her working time, this is sufficient to satisfy the control requirement in exclusionary subparagraph (ii) of the definition of remuneration in the Fourth Schedule of the Act (SARS, 2019:15). An employer’s exclusive entitlement to all of a worker’s productive hours is a near-conclusive indicator of an employer-employee relationship (SARS, 2019:15). An independent contractor relationship, on the other hand, is evidenced by the ability to determine the hours and times of work.

In cases where a letter of appointment states the hours to be worked and freedom to determine those hours then the essence of a relationship is that of employment (Erasmus, 2006). The fact that hours of work are not included does not necessarily invalidate the contract. The determination of hours of work for the worker for a specified period is enough evidence to indicate control or direction. Flexible working time arrangements are also available in employer-employee relationships (Worklaw, 2021).

Therefore, based on the above analysis, it should be noted that the extent of control exerted by the employer over the employee is critical when making a judgement on an employer-employee relationship.

2.5.1.3 Indicators resonant of an employee relationship or an independent contractor relationship

The category of these indicators gives an idea as to the manner in which the relationship is viewed by parties involved. They therefore tend to provide the true nature of the relationship and create an immediate or superficial impression of the relationship (SARS, 2019:16). These indicators are discussed below.

- **Tools, materials, equipment**

The provision of working tools, equipment and materials by an employer usually indicates an employment relationship (SARS, 2019:16). An independent contractor usually owns the

necessary tools, materials, stationery and equipment (SARS, 2019:16). There is nothing wrong with the employer providing tools and equipment to an employee without payment; for example, the use of telephones or computers (Nelson, 2020).

- **Office or workshop**

An independent contractor usually operates from his or her own office/workshop and works temporarily at the client's premises. When an employer provides an independent contractor with an office or workshop or works continually or permanently at the client's place of work, this suggests dependence which indicates an employer-employee relationship (SARS 2019:16).

If a person is working at one place and not at his/her own place of business, this might indicate a relationship of employment. Working at different places, including that of the employer's premises, does not nullify an employer-employee relationship (Worklaw, 2021). In recent times working from home is becoming a norm and employers make it possible by providing the necessary equipment for working remotely.

- **Integration in employer's usual work premises**

When an independent contractor is working from the employer's workplace, a degree of dependence is prevalent. This indicates the likelihood of an employment relationship (SARS, 2019:18).

- **Integration in employer's usual business operations**

When a person's daily activities form an integral part of the organisation it may indicate that the person is part and parcel of the business organisation. This is an indicator of dependency and that an employer-employee relationship is likely to be present, whereas an independent contractor is in essence another employer running a separate business (SARS, 2019:16).

This usually takes place when the employer is a corporate entity. In this case, the worker forms part of the employer's operations, unlike a domestic worker, for example, who is obviously an employee. A supply of service in conducting personal business interests does not mean being an integral part of the employer's business (Labour Guide, 2006). This is applicable for a worker under an entity that is registered, and that services other businesses for which it cannot be said that such a person forms part of an employer's organisation. Some indicators of operating an independent business include the bearing of risks of losses, as previously mentioned. In an employment relationship, the employer usually bears these risks (Labour Guide, 2006).

- **Integration or hierarchy and organogram**

When a person has a job description and a position in the employer's organogram, this will indicate an employee status and is also an indication of how the relationship is perceived by both parties (SARS, 2019:16).

- **Duration of relationship**

A contract of service (employment contract) will be terminated at the end of the period in which service was entered. A contract of work (independent contractor) terminates on completion of the specified task or on production of the specified result. An employment contract is in general an open-ended contract with no fixed term while the employee renders services on a permanent basis to the employer until the period of service terminates (SARS, 2019:17).

In Erasmus (2006) it is indicated that a contract of employment normally comes to an end immediately after the death of an employee. This is not the case with a contractor as his employees will continue with the appointment as normal. This will not apply in cases where a contractor is a single individual without employees, in which case death will obviously terminate the appointment (Erasmus, 2006).

- **Termination and breach of contract**

An employment relationship is likely to exist if the employer has the power to dismiss a person. Control seems to exist especially when an employer threatens to terminate the employment of a worker. In this case, an employment relationship is seen to be prevalent. If an employee has the right to resign or an employer has the power to dismiss before the results are achieved or a specific task is completed, this indicates an employment relationship (SARS, 2019:17). An employment contract comes to an end when the term of service expires.

A contract might be terminated for various reasons; for example, upon dismissal by the employer or the resignation of the employee. When a contract is a fixed term, temporary or project contract, normally the termination date is indicated therein (Labour Guide, 2006).

- **Significant investment**

When conducting a business, the owner or employer requires significant investment such as tools, training, materials, premises, support services and other infrastructure. In an employer-employee relationship, an employee has no investment to contribute. By contrast, an independent contractor has to make a significant investment in their own business (SARS, 2019:17).

Usually the contract, in the case of an independent contractor, will be of shorter duration when significant uncertainties exist in the proposed relationship and the service provider is not required

to make any significant investment. Logically, the opposite is applicable if the contract period is to be longer (Slater, 2001).

- **Bona fide business expenses, bona fide statutory compliance**

An employee does not bear the cost for any business expense. This is the employer's responsibility. The employee is reimbursed on any expenditure incurred on behalf of the business. An independent contractor will incur business expenditure, which will be recovered in the contract price quoted to the client. An employee is not eligible to register with SARS for VAT or employees' tax (SARS, 2019:19).

Within an employer-employee relationship, it is the responsibility of the employer to withhold employees' tax from earnings paid, as required by law. This is not the case with a contractor; instead, a contractor has the responsibility to manage their own tax affairs unless an arrangement has been made where the employer has agreed to withhold tax from the fee paid. A strong indicator of an employment relationship is however evidenced by the deduction of taxes from a worker's earnings (Erasmus, 2006).

Based on the prior discussion, it should be noted that this category of indicators provides a guide as to how parties perceive their relationship. Some of these indicators provide evidence of an immediate existing relationship and some might be susceptible to deceptive contractual manipulation.

2.6 Conclusion

In this chapter, the classification criteria applied in South Africa when determining the taxation status of an independent contractor (that is, to be classified as an independent contractor as opposed to being taxed as an employee) as envisaged by the Act read with IN17 was analysed. This chapter has discussed what characterises a relationship of an employer-employee and that of an employer and independent contractor, from SARS' perspective.

This chapter began by differentiating between employee and independent contractor as the distinction is critical in determining their employees' tax status which depends on who is receiving remuneration as indicated in the Act. In establishing the relationship, the statutory test was discussed, and this led indirectly to providing the meaning of the term "independent contractor". In a situation where the relationship is not clear, the IN17 is applied to clarify the relationship. When applying the IN17, statutory test is first applied and then the common law dominant impression test follows.

For the purposes of this study, the methods applied in Germany and Australia in differentiating between employee and independent contractor for income tax purposes are considered. The methods of these countries are discussed in the chapter that follows.

CHAPTER 3 TAXATION OF INDEPENDENT CONTRACTORS AND EMPLOYEES IN THE CONTEXT OF SELECTED DEVELOPED COUNTRIES

3.1 Introduction

The goal of this part of the research is to consider the procedures followed by Australia and Germany when determining the classification of employees and independent contractors for income tax purposes. The procedures followed by these two countries will be analysed as the means to establish if there is a refined process that could perhaps be of assistance in developing better classification criteria in South Africa for income tax purposes.

The approach followed in the discussion that follows is first to analyse the criteria implemented in Australia when classifying an employee and an independent contractor for income tax purposes; and second, the criteria applied in Germany.

3.2 Classification criteria followed in Australia

3.2.1 An overview

In Australia, an ICA was established in 1999. It is an organisation without profit motives and formed under the Association Incorporation Act of 1981 of Victoria (ICA, 2020). According to ICA (2020), 1.1 million independent contractors are registered in Australia with Other Business Operators (OBO) working as self-employed contractors amounting to one million workers with a total workforce of approximately 11.3 million. The purpose of establishing the ICA was to represent independent contractors in the Australian workplace. As in South Africa, an independent contractor is defined as a person, business, or corporation that provides goods or services under a written contract or through a verbal agreement (ICA, 2020). In comparison with ordinary employees, independent contractors do not work regularly for their employers but work as required.

According to the Independent contractor essential handbook (Independent contractor, 2012:4), independent contractors in Australia are distinguished from employees by some key differences for tax purposes. For example, if a person is classified as an employee, an employer must withhold employees' tax from salary paid and pay it over to Australian tax authorities. In the case of an independent contractor, the business entity being operated in is taxed independently on the income generated in accordance with Schedule 1 of the Taxation Administration Act of 1953. A

brief discussion of Australia's classification of employee and independent contractors for income tax purposes follows.

3.2.2 Legal framework

3.2.2.1 The general distinction

According to L&E Australia (2017) the difference between employers and independent contractors in common law is described in the court cases of *ACE Insurance v Trifunovski* (2011), *Hollis v Vabu Pty Ltd* (2001), *Marshall v Whittaker's Building Supply Company* (1963). In these cases the courts concluded that the distinction is:

"rooted fundamentally in the difference between a person who serves his employer in his employer's business, and a person who carries on a trade or business of his own..."

The presence of an employment contract provides evidence of the existence of an employer and employee relationship. It was established that an employment contract serves as an agreement into which the employer and employees entered. The employee is entitled to a consideration in the form of a salary or wage after providing a service of personal labour. In the *Stevens v Brodribb Sawmilling Co Pty Ltd* (1986) case, the courts established that the conducting of business to provide services to a principal, serves as evidence of an independent contractor.

The operation of the law in Australia is that it is expected that an employee must be obedient to an employer and must execute his/her duties in accordance with given instructions (L&E Australia, 2007:30). In the case of *Concut Pty Ltd v Worrell* (2000) and that of *Pearce v Foster* (1886) the courts involved reference to terms of faithfulness in contracts. The employer has the right to dismiss the employee in a situation where an employee is engaged in anything not in accordance with the given instructions. On the other hand, an independent contractor's work will usually involve the acquisition and use of both tangible and intangible assets in the pursuit of profit and therefore no such duties of fidelity and loyalty arise (*Minister for Employment and Workplace Relations v Gribbles Radiology Pty Ltd*, 2005; *On Call Interpreters and Translators Agency Pty Ltd v Commissioner of Taxation*, 2011).

3.2.2.2 The legal test

In the *ACE Insurance v Trifunovski* (2011) case it was held that as there is no legal definition of "employment" in the Australian income tax legislation, the common law test was developed mainly to establish vicarious (acting or done for another) liability in offence. The common law test applied involved a number of factors to be considered when establishing the employment relationship (*On Call Interpreters and Translators Agency Pty Ltd v Commissioner of Taxation*, 2011). The test was pursued to determine whether the business tailored by the employee was that of an employer

or an independent contractor (*ACE Insurance v Trifunovski*, 2011). This test was designed to investigate the totality of the relationship (*Hollis v Vabu Pty Ltd*, 2001) and entails scrutiny of silent features indicating employment and independent contractor relationships. The features are then utilised by authorities to establish whether the relationship is that of an employee or independent contractor (*Stevens v Brodribb Sawmilling Company Pty Ltd*, 1986; *Hollis v Vabu Pty Ltd*, 2001). The common law or multifactorial “totality” test (the indicators) as applied in Australia for tax purposes are categorised into those indicators giving rise to an “employer-employee” relationship and those which are indicative of an employer-independent contractor relationship (L&E Australia, 2007).

According to Napier (1987), the indicators are not exhaustive, and each case must take into account its own features when deciding on the nature of the relationship. In the process of making decisions, courts will consider the relationship of both parties at the place of work as this will likely reveal the true nature of the relationship (Napier, 1987). Below is a more detailed look at the relevant indicators.

- **Control**

When establishing the nature of the relationship, the courts consider the level and degree of control and this seems to carry more weight than other factors. This is established in the case of *Marco Investments Pty Ltd v Amor* (2004) where the courts established that the extent of control by one party over the other is critical when making a decision on the nature of the relationship. In this case control refers to the management of work assigned and to be carried out. The existence of direction and supervision of the work that has to be carried out constitutes the authority of control (*Marco Investments Pty Ltd v Amor*, 2004).

Generally the courts will evaluate the extent of control being exercised and this will determine the likelihood of an employer-employee relationship. The control element is satisfied even if workers enjoy freedom in terms of selection of hours or other significant choices as long as all the production processes are handled by the organisation (*Marco Investments Pty Ltd v Amor*, 2004).

- **Mode of remuneration**

When considering the manner in which remuneration takes place in a relationship, the modern method of payment compels the courts to take other factors into account. For example, when remuneration is paid with reference to the number of hours stipulated in the timesheet, this method of payment indicates a relationship described as an employer-employee one (*Country Metropolitan Agency Contracting Services Pty Ltd v Slater*, 2003). As part of evaluating the relationship in relation to the manner in which remuneration is paid, the court considers if the payment is made on a periodic basis, which could be regarded as further evidence of an

employment relationship. Generally, if a price for the service to be rendered is negotiated prior to the work being done and the payment for the work already completed is based on the invoice submitted, this has the essential character of an independent contractor relationship (*Country Metropolitan Agency Contracting Services Pty Ltd v Slater*, 2003).

In a case where a company generates and issues invoices to itself on behalf of its contractors, the court will examine the process. In *ACE Insurance v Trifunovski* (2011) it was however found that invoices generated by the recipient were similar to payslips normally issued by an employer. This was interpreted as evidence of a contractor relationship (*ACE Insurance v Trifunovski*, 2011). The courts also considered who bears the risk for unsatisfactory completion of the work, and if the employer does, an employment relationship is prevalent; otherwise an independent contractor relationship is possible (*B D Investments Pty Ltd v Workers Rehabilitation and Compensation Corporation*, 1994).

- **Provision of tools and equipment**

Provision of tools and equipment is another factor considered by the courts when establishing the nature of the relationship. In most cases, if a person invests in and maintains his or her own tools and equipment, courts will perceive a contractor relationship (*Stevens v Brodribb*, 1986). In instances where an employer provides equipment for the enjoyment of a worker, the relationship will remain to be that of employer-employee (*Yaraka Holdings Pty Ltd v Gilijevic*, 2006).

In the *Australian Air Express v Langford* (2005) case it is stated that an employee who uses a vehicle to perform a service for an employer will not necessarily become an independent contractor merely by providing an expensive piece of equipment. By way of contrast, where couriers who were responsible for providing and maintaining their own bicycles were found to be employees, the court noted the relative capital cost of such a burden and required that the employees be reimbursed? Conversely, in the case of *Australian Air Express v Langford* (2005), the owner-driver of a truck was found to be a contractor by virtue of the capital investment.

- **Representations to third parties**

If employment requires a worker to transport goods on behalf of the employer during working hours, this is clearly an indicator of an employment relationship and wearing a uniform with a company logo during the delivery affirms the employment relationship (*Hollis v Vabu Pty Ltd*, 2001). Once again, the requirement to use company stationery and emails for communication with customers also indicates that there is an employment relationship.

- **Risk and liability**

In the case of an employment relationship, the employer bears the risks and assumes responsibility for any errors committed by an employee (L&E Australia, 2007:33). By contrast, contractors themselves bear risks in conjunction with the business and usually arrange for their own insurance (*B D Investments Pty Ltd v Workers Rehabilitation and Compensation Corporation*, 1994)

- **Business expenses**

The court will consider who bears the responsibility for expenditure in the business. The contractors carry the burden of their own overheads, and arrange their own insurance policies and licenses. By contrast, an employee is reimbursed for any costs incurred in connection with performance of employment duties (L&E Australia, 2007:33).

- **Exclusive engagement**

Employment is characterised by the provision of services by a person exclusively to the employer, while a contractor has the liberty to perform work for others. However, the legal systems have proved that freedom to work for others may be deceptive (*Re Porter; Re Transport Workers Union of Australia*, 1989). In this case the court takes into account “*the level of economic dependence of one party upon another, and the manner in which that economic dependence may be exploited*” in applying this test as it was held in *Re Porter; Re Transport Workers Union of Australia* (1989).

- **Separate place of work and advertising services**

A separate place of work is one critical indicator leading to a strong argument of an employment or contractor relationship. The court will take this into account and if it appears that the worker is carrying on the business personally and at a location separate from that of the employer, the court will favour the view of a contractor relationship (*Stevens v Brodribb*, 1986). This category is somewhat linked to the control test discussed above as the results of working at the employer’s place of work regularly implies an employment relationship (*Stevens v Brodribb*, 1986).

In the *Abdalla v Viewdaze* (2003) case, the court demonstrated that advertising a business without reference to an employer will result in the pursuit of contractor relationship. Furthermore, the court will investigate if a person is allowed to work for others concurrently with the employer. Usually, an indication of a contractor relationship exists if they are allowed to do so, otherwise an employment relationship arises (*Abdalla v Viewdaze*, 2003).

- **Right of delegation**

Performing the work personally as required by employment is often an indicator of an employment relationship. When assessing the relationship and it appears that a person may delegate work to others either through recruitment or subcontracting without consent of another party contracting their service, the court will find this to be evidence of an independent contractor relationship (*Australian Air Express Pty Ltd v Langford*, 2005).

The power to delegate seems to be an important criterion to be considered when deciding on the true nature of the relationship and this will be dealt with in the discussion below. In the Appeal Court in *Australian Air Express Pty Ltd v Langford* (2005) it was held that when a decision has to be made as to whether a person is in an employment relationship, the totality of the relationship is what is important and as such the right to delegate or provide a substitute carried significant weight but was not completely decisive (*ACE Insurance v Trifunovski*, 2011).

- **Employment benefits and obligations (Taxation, Superannuation and Leave)**

When assessing the relationship, the treatment of employee benefits and obligations are considered by the courts. The benefits are likely to include leave entitlement while the obligations include deductions for tax purposes and superannuation guarantee contributions (SG, 2018). If the worker is entitled to these benefits and obligations, the relationship is deemed to be that of employer-employee. In the case of a contractor, a pre-tax fee is paid by the employer, there is no leave entitlement and the contractor is responsible for their own tax affairs and other employment obligations (L&E Australia, 2007:34).

- **Nature of the work**

The court will also consider the level of skill required in the work. An independent contractor is generally skilled in nature. The presence of unskilled labour provides evidence of control by an employer and therefore suggests a relationship of employer and employee. The court considers professionals and tradespeople as the two most significant groups to be self-employed. A requirement to hold a licence if the person is not considered an employee is only a minor consideration when attempting to classify them as a contractor (*Abdalla v Viewdaze*, 2003).

- **Express label given to the relationship**

The general approach followed by the courts when deciding on the nature of a relationship is that express labels (what the relation is called) are set aside, and the true nature of the relationship is considered in practice (*Abdalla v Viewdaze*, 2003). The courts consider express labels in cases where there is uncertainty in defining whether there is an employee or contractor relationship. In this case, the way the parties characterise the relationship is considered and their perceptions

and intentions are documented as part of the overall factors are to be taken into account. In *Re Porter; Re Transport Workers Union of Australia* (1989), Gray J noted:

“The parties cannot create something which has every feature of a rooster, but call it a duck and insist that everybody else recognises it as a duck ... [T]here is no particular reason why a court should ignore the practical circumstances, and cling to the theoretical niceties...”

- **The power to incorporate**

Most independent contractors are companies rather than individuals. This is because companies are not necessarily regarded as employees. In the Australian Federal Court it was found that the rights to incorporate may also result in an employment relationship. The substance of the relationship will be considered by the Courts with little weight on the power to incorporate as *“the entity selected to do the work... was the individual..., and the company featured only as the recipient of the fees that would otherwise have been paid to the [individual]”* (*ACE Insurance v Trifunovski*, 2011).

The exception to the above rule occurs when the employee delegates or subcontracts work if necessary, provided that permission is sought from the employer (*Queensland Stations Proprietary Ltd v Federal Commissioner of Taxation*, 1945). In these circumstances, the worker will almost always be classified as a contractor. However, where that power requires approval by, or conditions to be met to the satisfaction of the employer, this indicator will be given less weight (*Australian Air Express Pty Ltd v Langford*, 2005).

- **Termination under common law**

In *Westpac Banking Corporation v Wittenberg* (2016), the court determined that in common law, an employee might be rightfully dismissed by the employer at any time only after the reasonable period of notice has been served. The State and Federal law play a crucial role in governing the termination of contracts of employment. In the case of contractor and employer, their relationship is administered by a contract which may be terminated without penalty in cases where the contractor has failed to deliver in accordance with the terms of the contract (Independent contractors, 2021:5).

- **Notice period**

When evaluating the relationship, the courts will consider if notice is required prior to termination of service. If notice is given, then this will weigh more towards an employment relation. The notice in this case is required in terms of Section 117 of the *Fair Work Act* 2009 (FW Act) which specifies that there should be a minimum period of notice that must be served to an employee or employer upon the termination of the employment relationship. Conversely, if notice is not given, it is

determined that the relationship is more that of an independent contractor as notice is not required in the case of termination of an employer and contractor relationship.

- **Unfair dismissal**

The courts will consider the manner in which an employee is dismissed and the available protection against this. If a person qualifies for protection in terms of Section 382 of the FW Act when unfairly or unjustly dismissed, then such a person is an employee as this protection applies only to employees. Independent contractors do not qualify for this protection.

- **Negligence**

The court will consider the responsibility of the employer in cases where negligence has occurred. In an employer-employee relationship, the employee is entitled to compensation in cases where there has been a breach by the employer during the employment. In the case of a contractor, the Appeal Court in Australia held that employers must still provide due care to contractors; however, not as extensively as the care provided to their employees. This is because an employer and a contractor are two separate entities, and as such a contractor is responsible for their own working systems (*Hollis v Vabu Pty Ltd*, 2001).

- **Vicarious liability**

Employers are vicariously liable for any act committed by their employees during the course of performance of duties (*Hollis v Vabu Pty Ltd*, 2001) and this does not apply in the case of a contractor (*Hollis v Vabu Pty Ltd*, 2001).

3.2.2.3 General differences in the tax treatment of employees and independent contractors

The manner in which employees and independent contractors are taxed differs fundamentally. In the case of an employer-employee relationship, an employer is obligated to deduct taxes from a salary or wages paid to an employee and pay that sum to the Australian Taxation Office (ATO) in accordance with the Taxation Administration Act of 1953. The maximum tax rate applies unless an employee provides the employer with a valid tax file number (ATO, 2017).

In contrast, a fee paid to a contractor is taxed in the contractor's hands at a rate applicable to companies in Australia. This rate is generally lower when compared to the rate levied on a natural person. A contractor is responsible for their own tax affairs; however, as an option of a contractor, the employer might withhold tax from fees payable and pay it over to the tax authorities (ATO, 2017).

The above discussion has shown that in Australia, the manner in which independent contractors and employees are differentiated for tax purposes depends on the totality of a relationship in

practice. The general provisions are applied originating from the outcomes of particular court cases and then the legal test of the relationship is determined by following the common law principle as the term “employment” is not covered by the Australian Income Tax Assessment Act of 1997. As can be seen, the determination of a relationship requires consideration of multiple factors and weighing them is of critical importance. Significant judgement is involved and the results are circumstantial. The discussion below deals with the consequences which could result should misclassification occur.

3.2.3 The misclassification of independent contractors as employees

From the foregoing discussion, it may be concluded that the presence of an employer-employee relationship is a question of fact rather than the law, and is incidental in nature. Therefore, in the absence of a fundamental change in the nature of the work performed, re-classification is procedural and results in compensation for any losses sustained by parties involved because of misclassification (L&E Australia, 2007:43).

For example, companies with payrolls amounting to \$750,000 or more per month might be liable for penalties for default in taxes. They may also have to pay significant penalties charged by ATO on interest for default on superannuation and non-compliance with PAYG withholding and reporting obligations (Roy Morgan Research v Commissioner of Taxation, 2010). In addition, a company may also suffer from reputational damage if it is found to have been a party to a sham contractual relationship intended to avoid liabilities associated with employment (Independent Contractor, 2021).

According to L&E Australia (2007) if a contractor is being absorbed by a company/employer, reasons for the change in status must be appropriately documented, and records must be kept for any discussion/agreements resulting in a change of status. The characteristics of employment must be distinguished from those in the previous position as a contractor and this should be put in writing. To avoid severe consequences arising from misclassification it is necessary to look at how the independent contractor relationship is structured in Australia. This is considered in the discussion that follows.

3.2.4 How to structure an independent contractor relationship

According to L&E Australia (2007:46), prior to engaging an independent contractor, the possibility for a contract of employment must be sought. In most cases, workers such as receptionists, factory workers and clerical employees may not be regarded as independent contractors (L&E Australia, 2007:46). If the work is appropriate for an independent contractor to carry out, it is important to ensure that a properly independent contractor agreement is drafted, which sets out the rights and obligations of each party (Utz, 2019:4). The contract should be transparent by making clear that the relationship is that of an independent contractor and principal. The contract should also stipulate the rights and obligations involved, similar to those of employer-independent contractor relationships as indicated in paragraph 3.2.2.2 above, and as suggested in *Electrolux Home Products Pty Ltd v Australian Workers Union* (2004). According to the Australian Business Register (ABR), a contractor must be duly registered and be provided with a unique Australian Business Number (ABN) and be regarded as an employer on their own (Simic, 2021). Where a company is contracted, the courts find that it is often not easy to establish if work is carried out by an employee (L&E Australia, 2007:46). As can be noted, appropriate structuring of an independent contractor with an employer may have a significant impact on the court's decisions relating to the relationship as the intentions of both parties are clearly written and therefore transparent.

Based on the foregoing discussion of classifying employees and independent contractors in Australia for income tax purposes, it is well-known that the FW Act and the courts have demonstrated a significant role in differentiating employees from independent contractors. This has been shown to be effective especially in employment situations where workers are being exploited. It became apparent that some workers without adequate business knowledge might be carrying out a trade without their knowledge, as determined by courts in the above discussion.

As discussed in the main objective of the study, the next step is to scrutinise the criteria applied in Germany when establishing the nature of a relationship between employer and employee and an independent contractor for tax purposes. This is discussed in the section that follows.

3.3 Classification criteria followed in Germany

3.3.1 An overview

According to VelocityGlobal (2019), employers must understand that German authorities actively seek out misclassified workers more aggressively than any other country. In Germany, independent contractors are identified from various situations, for example during the audit by German tax authorities, during investigations conducted by a prosecutor for social security contributions, or when termination of employment contracts arises (International Labour Office, 2016:54; L&E Germany, 2017:185). According to Wessing (2021), German law describes contractors (also known as consultants, self-employed persons or freelancers) as persons who carry out work under a private law contract and, crucially, who have the freedom to determine the content of their work and details regarding how they carry out their services.

If employers err in their classification, or intentionally try to avoid an employment relationship, several risks are involved (OECD, 2019). According to Innangard (2019), the employer will be held liable, for example, in cases of taxation, loss of the entitlement to deduct input tax; and repayment of outstanding income taxes with a high risk that remuneration paid to a contractor will be regarded as intended payment. Thus, taxes and social security contributions will be calculated on projected gross income (VelocityGlobal (2019).

Under German law, should it occur that both the employer and the contractor doubt the existing status of a relationship, they may report to the relevant authorities as a means of declaring their existing relationship status (L&E Germany, 2007:18; International Labour Office, 2016:52). This kind of declaration will ensure that the parties appear transparent with regard to their intentions and provide clarity with regard to the status of their relationship. However, in arguable cases the authority will often rule in favour of the status of an employee, where the status of an independent contractor may very well be admissible (L&E Germany, 2007:185).

As is demonstrated above, it is of utmost importance to ascertain how the German authorities determine what constitutes an employee and an independent contractor for tax purposes. This is discussed in detail below.

3.3.2 Legal framework

In Germany, the differences between an employee and an independent contractor are not regulated by a single definite regulation (VelocityGlobal, 2019). There is a strict assessment under several criteria, arising partly from German law regulations, but mostly from rulings of the German labour courts and the German administrative courts (L&E Germany, 2007:185). The courts apply

marginally different assessments when establishing if a person is an employee or an independent contractor. The assessment in these courts results in different outcomes as to the status of the relationship; however outcomes depend on the application of the same criteria (L&E Germany, 2007:185).

3.3.2.1 General distinction

Under German law, numerous criteria are used when establishing whether a person is an employee or a contractor. According to *Handelsgesetzbuch*, often referred to as HGB (a law that governs the primary commercial code for companies in Germany regulating the legal relations of merchants and therefore also designated as "the special private law for merchants"), a critical feature for independent contractors is the ability of a person to freely determine his own performance as well as his own working time to carry out the service (Wessing, 2021). In HGB (1989) it is stated that when performance, instructions and working times of a worker are determined by the employer then a worker is an employee.

As these criteria have proven to be rather inexplicit, especially with regard to a person earning a flexitime wage and performing highly specialised jobs, and where no other statutory regulations exist, the German Federal Labour Court (*Bundesarbeitsgericht*) considers the distinction between an employee and a contractor to be the degree of personal dependence on the employer (L&E Germany, 2007: 185). The existence of dependency is a strong indicator of an employment relationship (Wessing, 2021). Dependency, according to the Federal Labour Court, is likely to exist when the scope of instructions is provided, for example, content and type of work, and the time, duration and place where work is carried out (L&E Germany, 2007:185). According to L&E Germany (2007), the court will, in addition to the above criteria, consider the overall legal status of a contractor by further assessing the following:

- how the given task is to be executed
- what are the bases of determining time to complete the work
- what are the bases of determining workplace
- what is the level of the contractor's dependence on the employer
- who benefited more from the service that was carried out.

The above criteria proved to be inadequate when assessing the relationship. Further criteria were introduced by social security authorities, and are designed to answer questions such as:

- is the work to be carried out in person by contractor or is delegation permissible
- who is responsible in cases where performance is not of the standard required
- is the contractor an integral part of the employer's business

- is the contractor's workplace at the employer's place of business? Is the contractor in a mailing or telephone number list
- is the contractor invited to the employer's regular meetings, training sessions or social occasions
- is the notice for holidays or any other leave served on the contractor
- is the remuneration paid on a fixed monthly basis or paid after service rendered
- is the invoice written
- is the contractor entitled to employee benefits offered by the employer; for example, sick leave or holidays
- is the contractor's business a registered or licensed entity
- is a contractor free to work for other clients
- what length of time is spent working for a single principal.

All of the above criteria are considered in totality by the courts. In their considerations, labour courts tend to focus more on the degree of personal dependency, whereas the social security authorities rely more on the economic dependence of a contractor (L&E Germany, 2007: 187).

Most importantly, the contractual relationship as documented is not considered when establishing the relationship; however, what is considered is how the relationship is conducted in day-to-day business. Thus, even if both parties involved are convinced that their contractual relationship is a service agreement, it may still be assessed as an employment relationship by German courts or authorities, and vice versa (L&E Germany, 2007:187). The courts may also consider other factors which indicate either employee or independent contractor status. These are discussed below.

- **Differences in benefit entitlement**

An employee, by virtue of statutory law, is entitled to certain benefits. By contrast, statutory law does not allow these benefits to be granted to an independent contractor. Should an independent contractor be granted employee benefits under statutory law, this may imply disguised employment. Examples of such benefits in Germany include paid holiday leave, paid sick leave and special allowances (L&E Germany, 2017:188).

- **Differences in protection from termination**

Employment is generally terminated for a valid reason. By contrast, an independent contractor may be terminated without reason, observing a contractual notice period (L&E Germany, 2017:188).

3.3.2.2 General differences in the tax treatment of an employee and an independent contractor

An employee and an independent contractor are taxed differently under German tax law. In the case of employees, their salaries are subject to wage tax, which is a withholding tax and is deducted by the employer from the employee's monthly gross salary and paid over to the German tax authorities. In the case of an independent contractor, the income generated for rendering services is subject to VAT (L&E Germany, 2017:187).

3.3.3 The misclassification of independent contractors as employees

According to Carré (2015), an independent contractor misclassification occurs when a worker who should be considered a direct employee of a business is in fact treated as a self-employed, independent contractor. In L&E Germany (2017:191) it is stated that the legal consequences of a misclassification are broad and involve comprehensive risks for the employer.

The amount payable for tax charged and social insurance contributes to misclassification. Businesses that misclassify, fail to pay mandatory payroll taxes, social security, medicare and unemployment insurance (Carré, 2015). Companies that misclassify workers and violate tax laws and are found out by the German tax authorities usually do not get penalised by federal authorities due to legal constraints. Not only are they not fined, they are often allowed to continue misclassifying workers under a tax loophole known as "Safe Harbor", a legal provision to reduce or eliminate legal or regulatory liability in certain situations, as long as certain conditions are met. Penalties only arise in the case of failure to pay social security contributions (Ordonez & Locke, 2014).

Upon re-classification, a contractor may be subsequently regarded as an employee and thereby become entitled to protection available to other employees; for example, protection against unfair dismissal (Tran & Sokas, 2017:63). The protection available in this regard falls under the German Protection Against Unfair Dismissal Act – Kündigungsschutzgesetz – often referred to as the Protection against Dismissal Act (KSchG). Under this Act, employees may not be dismissed without a valid reason and required notice period (Seifert & Funken-Hötzel, 2005:7). The employer may no longer terminate the contractual relationship without a valid reason. In order to avoid the consequences resulting from misclassification, L&E Germany (2007) recommend appropriate structuring of the relationship for purposes of transparency, as discussed below.

3.3.4 How to structure an independent contractor relationship

Under German law, a service agreement in written format is not necessary, however it is preferred, for record purposes (International Labour Office, 2016:8). All documents used for correspondence such as declarations, invoices, business cards, references or representations must be maintained and kept safe as evidence (L&E Germany, 2007:193).

The above analysis of classifying employees and independent contractors has shown that in Germany an employer also has the right to choose whom to employ: an ordinary employee or a contractor. This decision dictates the nature of the work. In terms of legal status, the critical criteria in differentiating an employee from a contractor are: where the work is carried out; the length of time; the manner in which the work is carried out; as well as its integration into the employer's business.

It should be borne in mind that when deciding on the status of the relationship, the employer must be aware of the possible consequences should a contractor be disguised as an employee. To avoid this, transparency should be ensured through proper structuring and management of the relationship.

3.4 Conclusion

In this chapter, the classification criteria for both employees and independent contractors for income tax purposes in Australia and Germany were analysed in order to establish how these countries classify employees and independent contractors so that the most accurate and appropriate classification could be adopted and utilised in South Africa for income tax purposes.

The misclassification of employees and independent contractors as indicated in the prior discussion has shown to result in severe consequences, particularly on the employer's side. This appears to be applicable in both Australia and Germany. Examples of these consequences include among others, penalties on unpaid taxes and social security contributions.

It is noted that there is a regulatory body of independent contractors in Australia (the ICA) which is not the case in Germany. When analysing the legal framework for classification in both countries as per the preceding analysis, the distinguishing feature of an employee in Australia is a person who serves his employer in the employer's business; and an independent contractor is a person carrying on a trade on his own, while the distinguishing feature in Germany is based on multifaceted criteria and is deduced from German law regulations and mostly from labour courts and German administrative courts. The analysis has shown that in both countries, there are other

factors that assisted the courts in deciding whether someone is an employee or an independent contractor.

With regard to the tax treatment, a person classified as an employee is subject to an employees' tax. This is applicable to both countries; however, independent contractors are subject to business tax on income in the case of Australia while VAT is charged in the case of Germany. This chapter closes by providing guidance as to how to properly document the relationship and the day-to-day management of such relationships. A detailed analysis of these findings and how they compare with tax treatment in South Africa will be provided in Chapter Four.

CHAPTER 4 SUMMARY, CONCLUSION AND RECOMMENDATIONS

4.1 Introduction

The main objective of this study is to determine if there is a more simplified and accurate classification method by comparing the classification criteria used in South Africa (in its current form) when determining the taxation status of an independent contractor with those of Australia and Germany.

Chapter two analyses the taxation of independent contractors and employees in South Africa and considers the classification criteria applied in South Africa when determining the taxation status of independent contractors as envisaged by the Fourth Schedule to the South African Income Tax Act 58 of 1962 and the IN17.

Chapter three examined the taxation of independent contractors and employees in the context of selected developed countries. In this chapter, the classification criteria used by Australia and Germany in determining the taxation status of independent contractors and that of employees were discussed. The chapter also covered the manner in which independent contractors and employees are taxed in these countries.

Chapter four provides an executive summary, the conclusion and recommendations of the study. It also identifies areas in which South African independent contractors' legislation may be lacking and suggests improvements.

4.2 Achievement of research objectives

The research objective has been addressed as discussed below.

4.2.1 Taxation of independent contractors and employees in South Africa

The objective was achieved by establishing exactly how employees and independent contractors are classified in South Africa. This was carried out by firstly analysing the Fourth Schedule to the South African income tax legislation and the IN17. Relevant information was provided in Chapter Two and confirmed the definitions of "employer", "employee" and "remuneration" as envisaged in the Fourth Schedule of the Act. The IN17 provides further guidelines in classifying employees and independent contractors.

Based on the evidence gathered, it was found that from an income tax perspective, the definition of remuneration is a determining factor when establishing who does not qualify as an independent

contractor. It was found that a person receiving remuneration as defined is not an independent contractor but an employee. The remuneration received is therefore subject to employees' tax which is withheld by the employer and payable to SARS.

Where it is not clear in a relationship as to who is an employee and who is an independent contractor, the application of the statutory test and common law test are recommended, as provided in IN17. The statutory tests determine if a person is carrying on their trade independently. A person is not perceived to be carrying on a trade independently if such a person is mainly rendering services at the premises of the payer or at the premises of a person to whom the service is rendered. Furthermore, such a person must be in control or supervision of any other person that renders the services. Even when the person that renders the services employs three other people on a fulltime basis, that on its own will be the decisive factor that results in that person being classified as an independent contractor. The common law test is applied through multifaceted criteria which could provide further evidence of an employee or independent contractor relationship.

4.2.2 Taxation of independent contractors and employees in the context of selected developed countries

This objective was achieved by establishing exactly how Australia and Germany arrive at the conclusion as to what constitutes an employee and independent contractor for tax purposes.

Based on evidence gathered, the following findings were made.

4.2.2.1 In case of Australia

Independent contractors are identified by applying a legal framework which is categorised by general distinction characterised by the existence of employment contract and the legal test.

These tests are determined under common law which considers existing court cases which dealt with differentiating employees and independent contractors. Outcomes from the court case suggest that an employee is someone serving a master while an independent contractor is someone carrying out a trade. The presence of an employment contract provides sufficient evidence of an employment relationship. The employee has to abide by the rules of the employer who may dismiss the employee in the case of a breach of the employment contract. Conducting a business to provide services is an indicator of an independent contractor relationship which has no obligations of fidelity and loyalty to employer.

There is no definition of the term "employment" in the Australian income tax legislation, and an employment/independent contractor relationship is defined by vicarious liability in offence.

Multiple indicators are considered when establishing the relationship including overall factors giving rise to an employment relationship and those resulting in the indication of carrying on a trade (para 3.2.2.2 of Chapter Three). It is noted that indicators considered to provide definite evidence of what kind of employment relationship exists are considered to be “control”, a “separate place of work”, “mode of remuneration” combined with other factors, and then the “power to delegate”.

The manner in which employees and independent contractors are subject to tax was also considered and it was found that where an employer-employee relationship exists, an employer is obliged to deduct taxes from salaries/wages paid to an employee and pay these over to Australian tax authorities. In the case of independent contractors, revenue generated is taxed at an applicable company tax rate (being lower than the tax rate applicable to employees) after deducting business expenses. Independent contractors are responsible for their own tax obligations; however, they may enter into an agreement with an employer to withhold tax on income paid.

There is a risk involved in instances where misclassification occurs and re-classification to employee status is sought either by law or otherwise. This will result in the payment of penalty taxes for default on any payroll tax payments. The employer may also face significant penalties from the ATO, including penalty interest for non-payment of superannuation and non-compliance with Pay-As-You-Go (PAYG) for withholding and reporting obligations. Finally, in the case of Australia, when structuring a relationship of an independent contractor, a contract of employment must be drafted to clearly describe the nature of the relationship before work is commenced.

4.2.2.2 In case of Germany

Independent contractors are identified through the general distinction and legal status of the relationship through common law.

There are numerous criteria which are used when establishing the nature of the relationship. For example, it is found that the critical feature for classification as an independent contractor is person’s ability to determine their own performance in their own working time to provide services. This is not the case in an employment relationship. The degree of dependency is also a strong indicator of an employment relationship. Under German law, the contractual relationship is not relevant; however, consideration is made as to how the contractual relationship is exercised on a day-to-day basis. Finally, the overall legal status of a relationship is considered and the deciding factors are given in paragraph 3.3.2.1 of Chapter Three.

The way employees and independent contractors are subject to taxation was also discussed. It was established that in the case of an employee, their salary is subject to wage tax, which is a withholding tax and is deducted by the employer from the employee's monthly gross salary and paid over to the German tax authorities. In the case of an independent contractor, the income generated by an independent contractor for rendering services is subject to VAT.

In instances where misclassification occurs, for example if an employee was wrongly classified as an independent contractor, no penalties are involved when it is found that taxation laws were violated due to the "Safe Harbor" protection and the same relationship therefore continues. Penalties are charged if it appears that the misclassification resulted in violation of laws regulating social security contributions. In cases where reclassification is sought, the independent contractor gains the status of employee and is entitled to all employment benefits. Finally, it was found that when structuring the independent contractor relationship, a written service agreement is not necessary, although it is recommended. Each employment relationship is investigated on its merits when establishing the nature of the relationship.

The findings in this chapter relating to classification criteria of an employee and an independent contractor which are used in South Africa, Australia and Germany are therefore summarised in Table 4-1 below. The classification criteria are categorised into General and Legal test distinction as follows:

Table 4-1: Comparison of classification criteria

Categories of criteria	South Africa	Australia	Germany
General distinction	Indicators of employment		
	<p>Employer control the manner in the work is done.</p> <p>Payment is for effort rather than results.</p> <p>The existence of contract of employment implies an obligation to work for employer.</p> <p>Worker has obligation to work on a full-time basis Employer is not allowed to serve other clients on his/her capacity.</p>	<p>Servant and master principle applies.</p> <p>Existence of employment contract is important in establishing a relationship.</p> <p>There is evidence of obedience to the rules of the master.</p> <p>Terms of fidelity and loyalty exist in all contracts.</p>	<p>Employee is bound by specific working time.</p> <p>Existence of degree of dependence to employer as indicated by instructions provided.</p>

	Risk related to employer's profitability is not relevant	Existence of rights of dismissal	
	Indicators of an independent contractor		
	<p>Absence of control of the manner in which the work is done.</p> <p>Payment is for results instead of effort.</p> <p>There is no obligation to perform work; a contractor has power to delegate.</p> <p>Time is not necessary, the results of specific task in necessary.</p> <p>A contractor has rights to serve other clients exist.</p> <p>Entitlement to profit and bears the risk of losses.</p>	<p>Carrying on a trade Business is conducted to provide service.</p> <p>Lack of obligations of fidelity and loyalty</p>	<p>Person determines their own performance in their own working time.</p>
Legal test	Indicators of employment		
	<p>Earn remuneration as defined in the Act.</p> <p>Rendering of services mainly at the premises of an employer or any other payer.</p> <p>Subject to control or supervision of any person</p>	<p>Existence of vicarious liability in offence.</p> <p>Control: supervision and direction are provided by employer.</p> <p>Remuneration is periodic and based on hours of work set out in time-sheets.</p> <p>Employer provides tools and equipment necessary for the work.</p> <p>Employer is liable for most of the mistakes of any employee.</p> <p>Employee is reimbursed by employer for any</p>	<p>Instructions are given to perform tasks.</p> <p>Entitlement to employment benefits.</p> <p>Determination of working time by employer.</p> <p>Work performed at employer's workplace.</p> <p>Provision of resources by employer.</p> <p>Integrated into employer's business organisation.</p> <p>Involvement in advertising activities.</p>

		<p>expenses related to employment.</p> <p>Work is carried out at employer's place of business.</p> <p>Employee is entitled to all employment benefits offered by employer.</p>	<p>Attendance of internal team meetings.</p> <p>Receiving fixed monthly remuneration.</p> <p>Covered for sick or holiday leave.</p>
Indicators of an independent contractor			
	<p>Carrying on a trade independently of employer.</p> <p>Employ three or more employees on a full-time basis throughout the year of assessment.</p>	<p>Invest and maintain their own tools and equipment.</p> <p>Payment is on pre-negotiated amount.</p> <p>Takes responsibility for any faults in their work.</p> <p>Has power to delegate work to others.</p> <p>Pays their own business expenses.</p> <p>Work is carried out personally at the location separate from that of employer.</p>	<p>Provision of service in person with rights to delegate.</p> <p>Bears the risk of poor performance.</p> <p>Works in separate location.</p> <p>Issuing invoices for payment.</p> <p>Existence of trade license or registered business.</p> <p>Termination of provision of service without reason.</p>

Source: Author's compilation of information presented above

4.3 Conclusion and recommendations

As indicated in the findings of the study, in South Africa, the classification criteria of an employee and an independent contractor for income tax purposes are deduced from both statutes and common law test. In Australia and Germany, only the common law test is applied. From the analysis of the differentiation of employees and independent contractors for tax purposes, it can be established that real life cases have been used flexibly in South Africa, Australia and Germany to help reach conclusions as to who may be classified as an employee or independent contractor. Drawbacks will only arise when an unusual case is encountered; however, there is nothing to stop courts from creating new laws.

As stated, South Africa, Australia and Germany all apply common law test when classifying employees and independent contractors. In South Africa, the criteria are categorised into near-conclusive, persuasive and resonant indicators (refer to Chapter Two). This is not the case in Australia and Germany.

In Australia indicators such as control, place of work, mode of remuneration and power to delegate provide the definitive evidence of a relationship. When analysing these criteria relating to Australia it could be concluded that to demonstrate the existence of control one needs to prove the extent to which a particular person is managing the work or provide direction or supervision. A person's place of work must be different from the employer's workplace in order to be an independent contractor. A person might be paid once the task is completed (independent contractor) or on a regular basis with reference to time (employee). Contractors are free with regard to hiring and firing. Employees have no such power unless directed by the employer.

In Germany the definitive evidence of a relationship is formulated by establishing the person determining the performance and working time, as well as the degree of personal dependence. If the employer determines how work is to be carried out, at what time, for how long and at what place then the relationship is that of employment.

The criteria as discussed above in relation to Australia and Germany are likely to be present in every situation where a distinction has to be made between an employee and an independent contractor. The application of these criteria is not complex as discussed in the preceding paragraphs and the likelihood for misclassification is minimal to non-existence. However the application could be difficult to apply in a particular structured relationship meant specifically to result in misclassification. Nonetheless from this discussion the criteria used by Australia and Germany are accurate, easy to apply and there is less chances of misclassification.

In comparison to South Arica and based on the research performed and after considering all the tests applied (refer to Chapters Two and Three) it can be concluded that criteria under common law used in Australia and Germany are similar to those applied in South Africa. The only advantage is that in addition to common law, the statutory test is applied in South Africa. The application of the statutory test takes precedence and only when the relationship is complex, the common law test as stipulated in the IN17 is followed. It is a matter of concern that with the application of the statutes in South Africa the direct definition of "independent contractor" is not provided. It is only stated that when payment does not constitute remuneration, the receiver of the payment is considered to be an independent contractor. The definition of the term remuneration is however provided in the Act. Another concern is that a person is regarded as an independent contractor when such a person is "carrying on a trade" independently of employer.

Once again, there is no direct definition of carrying on a trade for the purpose of independent contractors in the statute, but what is provided are the instances when a person is not carrying on a trade, for example the premises-test and control or supervision-test as discussed in paragraph 2.4.1. The IN17 also fails to address this weakness in the statute; instead it follows the processes as portrayed there.

The application of the statute in South Africa has however provided a platform meant to eliminate complexities when classifying employees and independent contractors. A recommendation in this regard is that the above definitions be formulated and incorporated in the Act as this could enhance the law regulating independent contractors in South Africa. Another benefit is that the application of these definitions, if enacted could result in less frequent application of the common law test and a reduction in possible misclassification which is likely to arise in cases when the common law is applied. This creates an opportunity for further research.

In conclusion, the findings in this study suggest that method used in South Africa for classifying employee and independent contractors for income tax purposes namely the application of both the statute and common law is superior compared to only the common law test applied in Australia and Germany. The statute in its current form in South Africa can be applied for common cases while the common law test is applied to more complex situations, a deficiency identified in Australia and Germany. The two tests can also assist to prevent the likelihood of misclassification resulting from structured relationships.

The sources consulted in respect of Australia and Germany have revealed a potential area for further research that could be carried out in South Africa. For example, extensive steps have been taken in those countries to eliminate the current practice of hiring a person as an independent contractor without knowledge of actually being an employee. This was achieved by establishing independent organisations aiming to regulate and protect independent contractors, a practice that has not been implemented in South Africa and from which independent contractors and the tax system in South Africa could benefit.

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