

Sagamore Hill. TAX NEWSLETTER.



"Understanding the Distinction: Tax Implications of Contract of Service and Contract for Service Agreements"

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Every month, we provide an analysis and insight in our view of one of the most downloaded tax [case law from our database](#).

In this month's newsletter, we take a look at the increasingly complex area of tax on employment income.

We will as well share further insights beyond the matters discussed in the case to keep you updated and in the know so as to enhance your compliance.

It is not a surprise that the case law with the most downloads from our [database](#) related to the employment income which happened to be landmark ruling that provides direction and clarity on issues of employees and consultants.

The case involved the China Road and Bridge Corporation Vs Commissioner of Domestic Taxes.

Back Ground of the case.

Kenya Revenue Authority conducted an audit on the appellant where it was established that the appellant had personnel from the National Police Service to man the Standard Gauge Railway during its construction between Nairobi and Mombasa.

The CRBC was thereafter assessed for PAYEE of 292M but objected part of the assessment amounting to 62M. An objection decision was latter issued by Kenya Revenue Authority amounting to 64.7M as PAYEE for allowances paid to the police officers attached to for services rendered.

The appellant was aggrieved because the service contract was between the government of Kenya and Kenya Railways. The contract further stated that the responsibility for the provision of the

security services was Kenya Railways.

CRBC was assessed on the fact that it was been required by the law to deduct and pay taxes from the allowances it paid to the police officers

CRBC further contended that it cannot purport to be the employer of the police officers as that would be against the constitution of Kenya Article 239 and 245 and the National Police Service Act section 45 and 71.

The appellant further relied on the decision arrived in the case of Everret Aviation Kenya Ltd Vs Kenya Revenue Authority with highlighted the ingredients of what would constitute an employee – employer. Amongst the facts to consider as highlighted in the case are, one has to;

- ❖ Be in control of the relationship
- ❖ Be in charge of determining the work to be done.
- ❖ Be in charge of giving instructions
- ❖ Be in charge of the overall assignment of duties.

And all these factors indeed pointed to the fact that the National Police Service was suited to deduct the PAYEE for the allowances paid to the police officers guarding the railway.

On the contrary, the respondent, Kenya Revenue Authority contended that in the forgoing, CRBC was indeed the party with the mandate to deduct the PAYEE and remit the same to the respondent.

The respondent relied on the Income Tax Act Sec 3(2) on the charge of tax. Further, section 5(2a) states that taxable gains and profits includes *any wages, salary, leave pay, sick pay, payment in lieu of leave, fees, commission, bonus, gratuity, or subsistence,*

*travelling, entertainment or other allowance received in respect of employment or services rendered, and any amount so received in **respect of employment or services** rendered in a year of income other than the year of income in which it is received shall be deemed to be income in respect of that other year of income: and that the act doesn't say **respect of employment AND services**.*



Further to this, a clause in the contract between the parties stated that *The employer shall upon request and at the contractors cost provide reasonable additional assistance to the contractor in matters of security.*

The respondent further states that the case would have been different should the appellant have paid the money directly to the National Police Service or Kenya Railways because then either of the two parties would have been the party liable for deducting PAYEE but in this instance, the allowances were paid directly to the police officers. Lastly, on the appellant stand they did not have the control on time the officers would be deployed, the respondent contended that any income earned is subject to PAYEE regardless if the income is earned in one day,

one month or one year. As such, the PAYE is relevant to income and not time.

Issues of determination.

In the light of the forgoing, the tribunal was left to examine two issues.

- a. Whether there exists employee – employer relationship between the CRBC and the police officers and if such would be a predictor of who had the mandate to deduct PAYE
- b. Whether the appellant has a statutory duty of deduction PAYE due from the police officers.

As to whether the employee – employer relationship exists;

The court observed that what existed between the CRBC and the police officers could at best be said to constitute a contract for services and not contract of services due to the following reasons.

The National Police Service Act Sec 45 states that a police officer shall always be considered to be on duty when required and shall perform duties and exercise powers granted to him under the act where they are deployed.

To further buttress it's stand, the appellant further relied on Halsbury's Law of England that stated that an employment is in popular language a post and is to be distinguished from a mere engagement in the course of the exercise of a profession or vocation.

Stressing that the definition of an employer is not sufficient as defined by the Income Tax Act the appellant said this should further be addressed by the employment Act which justifies that being an employer goes beyond the party that pays emoluments.

As regards the different criteria mentioned elsewhere in this newsletter on the determination of employer and employee relationship, the appellant had the following responses. That to be an employer, one had to;

- ❖ Be in control of the relationship- The NPS Act provides for the control, organization and composition of its members.
- ❖ Be in charge of determining the work to be done and payment. - CRBC didn't determine the amounts payable to the police officers and they only paid directly to the police for ease of administration and that NPS was fully aware of the amounts the police officers were receiving.
- ❖ Be in charge of giving instructions - The constitution of Kenya provides that no person may give direction to Inspector General with respect to the employment, assignment, promotion, suspension or dismissal of any member of the NPS and therefore CRBC couldn't control the police officer deployed to the SGR
- ❖ Be in charge of the overall assignment of duties - The nature of services provided by the police officers, being that of guarding the SGR was such that they could not be under the direction and control of CRBC.

This therefore put to rest the contentious matter of where what existed was a employer – employee relationship.

However, according to the tribunal, there was the second issue that determined who had the mandate to deduct PAYE.

Whether the appellant has a statutory duty of deduction PAYE due from the police officers.

Having established that employer-employee relationship did not exist between the CRBC and the police service, the next question was who had the mandate to deduct PAYE and this could be resolved by looking at the operation of PAYE.

In arriving at its decision, the tribunal relied on several provisions as envisaged in the Income Tax Act which provides as follows.

Sec 3(2) provides the following;

Subject to this Act, income upon which tax is chargeable under this Act is income in respect of

- gains or profits from;
 - I. Any business for whatever period of time carried on
 - II. Any employment or services rendered.



Further Sec 5(2) provides that

For the purposes of section 3(2)(a)(ii) "gains or profits" includes—

- (a) any wages, salary, leave pay, sick pay, payment in lieu of leave, fees, commission, bonus, gratuity, or

*subsistence, travelling, entertainment or other allowance received in respect of employment or services rendered, and any amount so received **in respect of employment or services rendered** in a year of income other than the year of income in which it is received shall be deemed to be income in respect of that other year of income:*



As such, the court was of the view that the allowances given to the police officers would fall within the ambit of the of the provision of Sec 3(2)ii and in this regard, the income is for services rendered and therefore, income received by the police officers can be categorized as income for services rendered and the same was therefore liable for tax, in particular PAYE deduction.

CRBC was therefore required by Sec 37(1) to deduct tax and remit the same. The section state.

Sec 37 (1) An employer paying emoluments to an employee shall deduct therefrom, and account for tax thereon, to such extent and in such manner as may be prescribed.

In light of the foregoing, the incidence of tax and statutory obligation to remit taxes in this

case was not triggered by the employer – employee relationship, but by the payment of emoluments to the officers and who has control over the amount being paid and all this fell on the appellant.

CRBC has the option to remit the money to NPS who would then deduct the PAYE and remit the same to Kenya revenue authority and therefore discharge the statutory obligation as to the payment of PAYE. Once the appellant made the decision to pay the officer directly, the obligation was on them for the said taxes.

It was thus determined that CRBC had the full responsibility to deduct and remit PAYE and therefore the objection decision was upheld compelling CRBC to pay Kenya Revenue Authority Ksh 64,716,060.

Our Take Away.

Employment income taxes has in the recent past seen a lot of changes come by and has had lot of improvements and advancement. This has mostly been as result of the change in the mode of working, to recruitment and globalization. From the refinement of taxation of ESOPS as highlighted in one of our recent newsletter that can be [accessed here](#), to the recent development of the introduction of Housing levy at the rate of 1.5% of the gross pay with the employer matching the equivalent of employees in contribution.

This has prompted many employers want to change the type of arrangement many have with their employees from that of employer - employee to consultant's type of arrangement. The motivation and implication is that this would reduce the employment costs since at the heart of it,

engaging a consultant would not require employers to match the statutory deductions that the employees make. The only requirement would, in most cases, and as specified in the respective tax act, to withhold a percentage of the payment that they make to the consultants in which case then, the employer would be liable should they not withhold the taxes.

On the side of the employees, the upside of being engaged as a consultant is that, it would give them the right to deduct expenses incurred in generating the income they receive in the course of the year such as rent, transport, fuel, telephone expenses. Additionally the consultants would as well have the ability in some instances be a secondary employee in different institutions assuming engaging them as consultants would come with a lot of flexibility. The only obligation on the side of the consultant is to calculate and pay **instalment taxes** should they project to have a tax liability of more than Ksh 40,000 per year.



We wish to clarify that the installment taxes are paid by end of the fourth month following every quarter, save for those in the agricultural sector who's 75% of installment taxes due by the ninth month and the last installment due by the twelveth month.

While it may look doable to engage employees as consultants, the discussion provided earlier in the newsletter clearly shows that there are determining factors or criteria that the Kenya Revenue Authority can use to determine if an engagement a person has would constitute that of employer – employee relationship and as such be regarded as a **contract of service** or that of a consultant regarded as a **contract for services**.

Some of services that would qualify as consultant services are where a business engages a person for reasons such as;

- Strategic planning and implementation
- Change management and organizational development
- IT system implementation and integration
- Financial planning and budgeting
- Marketing and branding strategy
- Human resources management and staffing
- Operations improvement and process optimization
- Compliance and regulatory affairs
- Risk management and crisis management
- Supply chain management and logistics.

As such, below is a detailed analysis of the criteria that can employed to give more insight to the business to help them determine if PAYEE or WHT would be due from them, as they strive to ensure compliance.

Description	Contract for Service	Contract of Service
Parties	Company and third party	Company and employee
Relationship of the parties	Independent consultancy	Employer-Employee
Control over the work	The third party is not bound to obey the instructions of the company	The employee is bound to obey the instructions of the employer
Ownership of all the rights arising from the work created out of contract	The company gets ownership after paying for the services to the third party	The company is by default the owner of the work done by the employee, except in cases of inventions.
Mode of payment	Solely paid on commission basis or by way of fees	Paid by way of wages, salaries.
Tools of work	The person engaged invests in their own tools of work	Employer supplies tools and other capital equipments.
Delegation of duties	It is inconsistent for the employer to delegate his duties	The employer can delegate their duties there under
Control of working hours	Hours of work not controlled by the employer	Working hour controlled by the employer.
Working Premises	Work can be carried away from the employers premises	Work can only be carried away with the authorizing of the employer. The employer has a significant say on where the work is done from.
Frequency of engagement	Services not required on daily basis but once every often times.	Frequency of the services is on daily basis.

While this list is not exhaustive, these are some of the factors a business or a business owner can use to determine what type of liability is due from them and proactively being complaint and avoiding future tax audits that would result to penalties and fines



If you wish to deepen your understanding of taxation, reading tax case laws is the most useful way.

At [Sagamore Hill](#) we have all the Tax Appeal Tribunal case laws classified in the tax categories that they fall in for ease of your perusal.

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