Employee VS Independent Contractor - Tax Solutions EA Kenya

Some Organizations especially in highly specialized industries e.g. mining, oil and gas exploration, I[i]T companies operate a team of employees made up of both employees and consultants. Independent consultants carry out the specific functions independently as directed by the management while the employee is under the control of the organization.

In the Income Tax Act ("ITA"), there are cases where a consultant as categorized by the organisation will actually be viewed as an employee by the tax authorities. This is a high risk area affecting different organisations especially multinationals and other large local companies in the extractive and information technology industries.

The treatment of employee benefits in Kenya is taxed at graduated rates from 10% to a maximum of 30% depending on the employees' gross chargeable income while the income of a consultant on the other hand is chargeable at different rates depending on the residency of the consultant (resident 5%, non-resident 20%), Double Tax Agreement ("DTA") status (different rates applied ranging from 12.5% to 20% depending on the Kenya DTA network) or whether the service provider is categorized as a petroleum service subcontractor (5.625%).

In both cases the employer or the company contracting for the services is the government agent mandated by the Income Tax Act ("ITA") to deduct the taxes applicable and remit the accurate amounts due to the exchequer. Failure on the part of the company to deduct the taxes applicable exposes the company to hefty tax demands in terms of principle tax due and accrued penalties and interests.

In cases of inaccurate classifications of employees as consultants, the consultants will pay taxes at lower rates as compared to employees, exposing the company to future tax adjustments and demand by the tax

authorities.

Contract of service and contract for service

Contract for service and contract of service are common law terms that are used to distinguish between the nature of service provided by a worker to employer. While the contract of service refers to a person who is in employment, contract for service refers to a person who provides services to his clients. This classification is important for two reasons:

1) The statutory protections that applies for example the rights and remedies of an employee under the Unfair Dismissals Act, the employers' liabilities for acts committed by employees (vicarious

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liability), work injury damages, right to join unions, minimum wages, annual leave, paternity/maternity leave, redundancy payments, statutory remittances – NS[ii]SF, N[iii]HIF, NIT[iv]A, HEL[v]B, amongst several others.
Independent contractors for example are responsible for their own torts and cannot claim work related injuries/damages. Simply they do not enjoy the above listed benefits.

2) Second reason is the system of taxation applied to each category. In contract of service P[vi]AYE system applies while for a contract for service the withholding system applies.

The courts over years have established a number of criteria to determine the nature of employment relationships. The general tests relied upon when evaluating whether an individual is an employee or consultant are listed below:

1) Mutuality of obligation test – in an employment contract the employer has an obligation to provide a continuous flow of work to the employee and the employee has an obligation to complete the continuous work. In other words it is a continuous flow of assignments without interruptions on a regular basis. In a contract for service he is only obliged to complete the agreed task and thereafter his obligation ceases. After the break, another assignment could be signed.
2) This element of non- continuous intermittent breaks in between jobs will most likely be a contract for service. Basically it is a relationship organized around the completion of a once-off piece of work.
3) In a contract of service the employee's work is done as an integral part of the business, whereas under a contract for service an independent contractor is hired to complete agreed tasks that are not integrated into the business but is only accessory to it.
4) The degree of control. The greater the direct control of the employee by the employer the closer the relationship becomes that of employee including the requirement to be at place of work during specified hours and a fixed salary. Even flex time has core hours. They must perform the tasks they are instructed to usually by the line manager according to their job specification and description.
5) Who provides the tools of trade and equipment - a consultant will traditionally employ his/ her own tools, risk is own capital, takes financial decisions, bears any loss and takes profit.
6) The number of paymasters- a consultant will in most cases engage with multiple and changing clients.
7) Ability to provide substitute – a consultant will be at liberty to engage

substitutes but with consent from the principal, whereas an employee must present themselves to work and cannot send someone else as a substitute.
8) Degree of financial risk – where risks and rewards substantially fall on the employer the higher the chance the

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relationship is that of an independent consultant.

9) Control of the assignment – in the case of a consultant the principal can prescribe what is to be done. He undertakes to produce a given result, but so that in the actual execution of the work he is not under the order or control of the master. He may use his own discretion in things not specified beforehand.
   In an employment contract he can not only order what is to be done, but how, where and when it should be done. He supervises and determines when the employee should be available.

10) Integration or organization test – an employee is integrated with others in the work place even though the employer does not necessarily exercise a detailed control over what he does especially for the skilled/expert employees like doctors. Being a vital part of the team in the work place is sufficient to categorize one as an employee. Under a contract for service, his work, though done for the business, is not integrated into it but is only accessory to it.
11) Whether a person in addition to the agreed pay receives other benefits like leave/holiday pay, pensions, sick pay, company cars, access to loans, medical insurance, staff canteens etc.

Courts have however cautioned that the tests are not to be used exclusively by themselves as they only serve as guides based on the facts of each case. *The hallmarks of a truly independent contractor are that he will be a registered taxpayer, will work his own hours, run his own business, work for more than one employer at the same time, invoice for work done* on agreed intervals and will not be subject to the usual employment matters such as PAYE, annual and sick leave, pensions, insurance, medical etc.

It is of paramount importance that per tax law the employer is the government mandated agent to deduct the taxes applicable and remit the same to the tax authority. Failure of this legally imposed duty exposes the employer to hefty penalties and interest and

in some cases prosecution may instituted.

Case law one:

Kapa Oil Company VS Kenya Revenue Authority ("KRA") - September 2011

Kapa Oil company ("KAPA")moved to court in May 2009 and sued KRA seeking orders to have e KRA prohibited from classifying the payments made to Mr. Ogode -the human resources consultant as salary. This was after the case collapsed at the local tribunal. Below is a summary of both the defendant (KRA) and appellant (KAPA) submissions.

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Arguments advanced by KRA to support employee status versus an independent consultant

1) Mr. Ogode offered human resource services to Kapa oil under the title of human resources manager;
2) His relationship with the company did not reflect the independence of a consultant;
3) He had been offered an office and was operating from the company's premises;
4) His pay was a monthly fixed salary and working hours from 8 a.m. to 5 p.m. just like an ordinary employee;
5) Mr. Ogode was in charge of staff discipline, a function not normally performed by external consultants;
6) In a letter of introduction to Nairobi Hospital Kapa refers to Mr. Ogode as their employee;
7) In one of the letters written by Mr. Ogode to the finance director he refers to himself as human resources manager and the letter was done on the company's letter head;

8) Kapa oil MD spelled out his duties as: providing human resource support to management, handling staff disciplinary issues, representing the company in trade disputes, chair health and safety committee, liaising with police on security matters and any other duties assigned from time to time.
9) The Income tax Act defines consultancy as payments made to any person for acting in an advisory capacity or providing services on a consultancy basis. Wikipedia defines a consultant as a professional who provides expert advice in a *particular area such as law, management, accountancy, medical etc.* He is usually an expert or a professional in *specific field and has a wide knowledge of the subject matter.* He usually works for a consultancy firm or is self employed and engages with multiple and changing clients.
10) Considering the duties and responsibilities of Mr. Ogode as set out in his contract, which are wide and varying in nature the judge was satisfied that indeed he was an employee of the applicant. She observed that there was total lack of independence in the performance of his duties and he was totally answerable to his employer. Her summary of judgment was that the applicant holding out Mr. Ogode as consultant when he was a regular employee, it is obvious that Kapa Oil was evading payment of PAYE and KRA acted in accordance with the law in its action to demand payment.

Arguments advanced by Kapa Oil in support of a consultant status

1) Mr. Ogode was hired under a trading name J.M. Ogode managing consultants and not as an employee;
2) He performed his duties as a human resources and management consultant;
3) The 5% withholding tax applied in his case and not PAYE;
4) In a letter to Nairobi Hospital Mr. Ogode had been informed that he will be responsible for his son's medical bill.

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Case law two:

Everret Aviation Limited (Applicant) Versus KRA (Respondent)

The dispute between Everret Aviation Limited ("Everret"), a Kenyan company providing helicopter charter services in Kenya and abroad and the KRA, involved taxation of freelance resident and non-resident pilots. Everret hired the pilots as independent consultants thus WHT being applicable to their income. The KRA after an audit of Everret's operations, demanded KES 6,699,425 for the years of income 2000 to 2002. Everret objected to the claim, however KRA confirmed the assessment.

Through their auditors, Everret appealed to the Income Tax Local Committee who ruled that; for resident pilots, PAYE is payable while for non-resident pilots, withholding tax is payable. The Appellant was dissatisfied with the decision and filed an appeal in the High Court. The facts of the case are as follows;

1) The company employed two sets of pilots: freelance pilots resident in Kenya; and, non-resident freelance pilots, on short-term contracts for services;
2) After auditing the company's operations, on 24th March 2003, the Commissioner of Domestic Taxes of the KRA made a claim for Pay As You Earn ("PAYE") tax on a scheme of salaries paid to the appellant's pilots;
3) Everret objected to the claim stating that the pilots were not employees of the company but were sub-contracted to undertake special tasks, for example to land on a ship and/or to train the appellant's employed pilots. The bone of contention was that the commissioner had treated payments made to the pilots as salary and hence the claim raised for PAYE tax as opposed to WHT tax;
4) Everret had negotiations with KRA which bore no fruit leading to the KRA rendering a decision on 29th May 2008, that there was no distinction between full time employees and freelance pilots;
5) KRA stated that both freelance pilots and pilots permanently employed render similar services and that freelance pilots are on a contract of service and not a contract for services. The mere fact of being subcontracted for short durations was not a bar to taxation under PAYE rules and Everret was under a legal duty to deduct PAYE and remit the tax to the KRA;
6) Everret submitted the following reasons

for the treatment of freelance pilots as consultants as opposed to employees; that they were not integrated into the appellant's business, the pilots would procure their pilot's licence independently, Everret could not dismiss them or force them to fly, pilots did not carry out management duties, were being hired for their special skills such as to carry a piece of machinery under their chopper and hover in the air until the machinery was bolted to the ground and

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that pilots would be employed for a few hours or a few weeks;

7) In short the Everret appeal was that they had no control over the pilots, were not integrated into the company's operations, the pilots were responsible for securing their tools of trade (licence), they were not on a monthly wage and thus the pilots were sub-contracted free pilots i.e. independent consultants;
8) The KRA responded with a simple answer: the engagement of freelance pilots is a contract of service (employment) and not a contract for services (independent third party);
9) Judge G.K Kimondo based his ruling on; the definition of an employer in the Income Tax Act ("ITA"), the definitions of an employee, employer and contract of service in the Employment Act and the various tests under common law of confirming whether a particular person is an independent consultant or an employee;
10) The tests relied upon by the Judge include;

- whether the person's duties are an integral part of the employer's business;
- The greater the direct control of the employee by the employer, the stronger the grounds for holding it to be an employment contract;
- The way in which the parties themselves treat the contract and the way in which they describe and operate it;
- Sufficient mutuality of obligations to justify a finding that there was a contract of employment;
- Control i.e. In the contract for service the master can order or require what is to be done, while in the contract of service he cannot only order or require what is to be done but how it shall be done;
- Was the contract of service within the meaning which an ordinary person would give under the words; and
- Case law suggesting that persons possessed of a high degree of professional skill and expertise such as surgeons and civil engineers may be employed on contracts of service notwithstanding that the employer has little control on use of their skills.

11) The judge ruled that, Everret was substantially in control of the freelance pilots, bore the risk of loss and profit chance, identified the task, determined

the pay, paid the pilots and dismissed them, provided the pilots with the tools of trade (fleet of helicopters), used its own capital, had special contracts and could force them to fly, therefore the freelance pilots were employees. Thus Everett was obligated by the ITA to deduct PAYE on the pilots income as opposed to the withholding tax.

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Conclusion

In determining whether a particular person is an employee or consultant, various tests in common law are applied. These include the *("MICE") test, covering, Mutual obligations, Integration of the person in the company's operations, Control of the person by the company and who provides the Equipment i.e. the tools of trade.*

Other factors include the number of paymasters, substance over form principle, degree of financial risk on the person, ability to provide a substitute, among various others.

In all cases, it's important to take a balance of probabilities approach based on the specific fact pattern. This means no individual factor, relied upon in classification of an employee/consultant can be conclusive in its own right. Different tests have to be combined in coming to a conclusion.

The recommendation to companies facing such uncertainties is consult their tax advisers to ensure a proper review of the facts before classification of one as either an employee or a consultant. In most cases, as was in the Everret case, the difference between the two will be quite slim, thus important to conduct a deeper review of the facts. This will minimize the tax risks exposure in relation to employee/consultant contracts, which may result in tax adjustments with accruals of penalties and interest.

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[i] Information Technology.
[ii] National Social Security Fund.
[iii] National Hospital Insurance fund.
[iv] National Industrial training Authority.
[v] Higher Education Loans Board.
[vi] Pay as You Earn.

Reference:
http://www.kra.go.ke/
http://kenyalaw.org/lex//index.xql

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