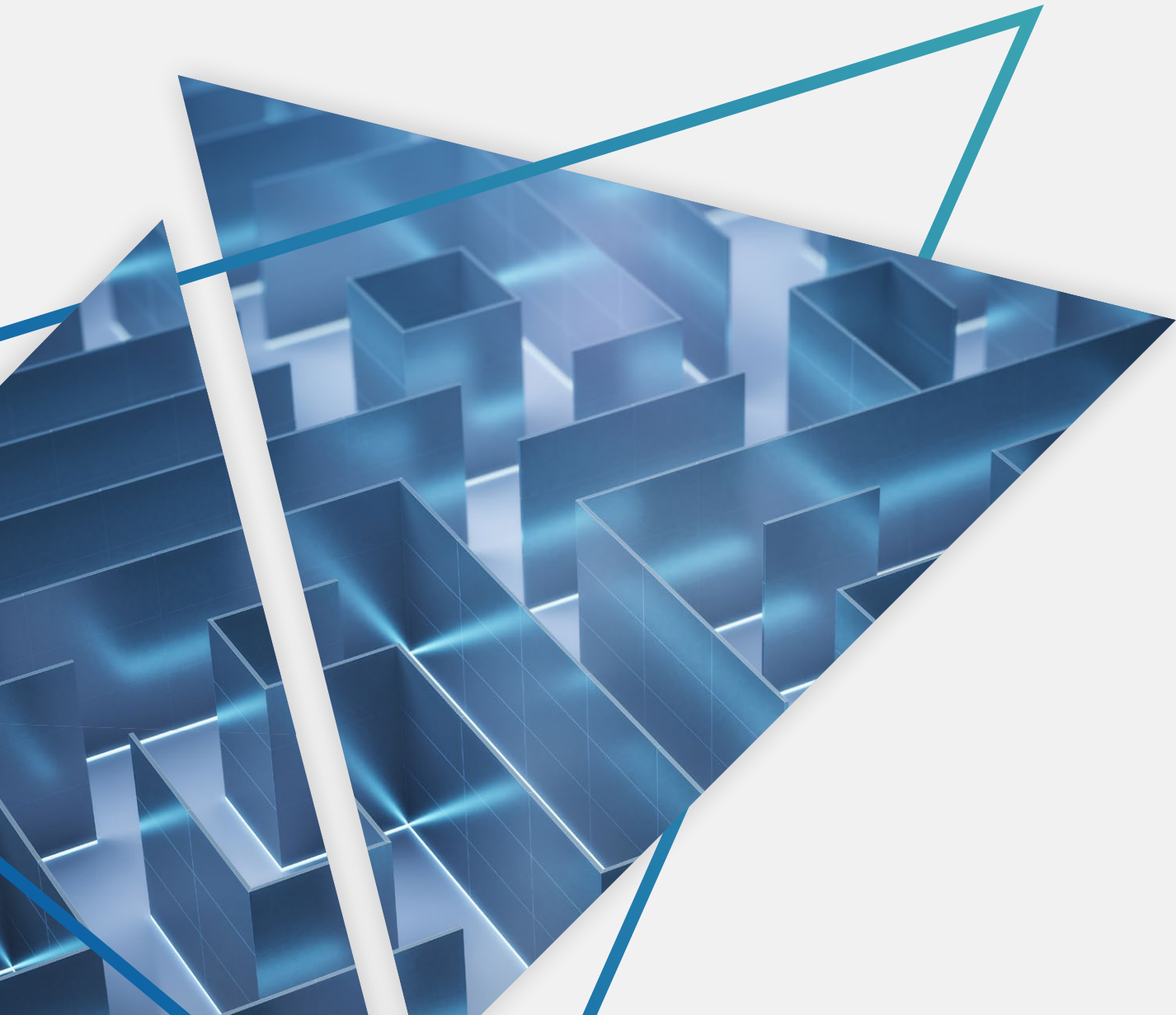


# Tax & Exchange Control

ALERT | 17 October 2024



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## Rethinking staff outsourcing contracts from a tax perspective

On 30 August 2024, the Tax Appeals Tribunal (Tribunal) delivered a judgment in Appeal E433 of 2024 (judgment), in which it held that the reimbursement of staff costs made by a charitable foundation (Foundation) to a non-charitable but related company (Related Co) under a staff secondment arrangement was subject to withholding tax (WHT) since the costs amounted to management or professional fees. This marks a departure from its earlier decision in *Two Lakes Packaging Services Limited v Commissioner of Domestic Taxes* (Appeal Number 420 of 2021) (Two Lakes), in which the Tribunal held that WHT should not be deducted from recharges of staff salaries.

In this alert, we summarise the Tribunal's finding and discuss what it means for secondment and staff outsourcing arrangements in Kenya.

### Brief facts of the case

The Foundation entered into an arrangement through which the Related Co was to second its employees. The Foundation would subsequently reimburse the Related Co a portion of the total salaries paid to the secondees.

The Kenya Revenue Authority (KRA) assessed the Foundation for WHT on the staff costs it was paying to the Related Co on the basis that these were payments for management and professional services.

### The Tribunal's finding

The Tribunal framed two main issues for determination. The first issue was whether these payments, termed as reimbursements, constituted consideration for a supply of services. The Tribunal analysed the agreement and determined that these payments were indeed consideration for the services rendered by the Related Co in providing its employees. In arriving at this decision, the Tribunal faulted the Foundation and Related Co for not having a tripartite agreement between themselves and the specific employees and said that the only evidence available for its decision was the contract between the Related Co and the Foundation.

The second issue revolved around whether the recharge payments should be classified as management and professional fees, which are subject to WHT. The Tribunal concluded that the payments made by the Foundation to the Related Co were for employment services provided through seconded employees. As these payments were made as consideration for the services rendered, the Tribunal affirmed that they qualified as management and professional fees, thus subjecting them to WHT.

Further, the Tribunal differentiated this case from the *Two Lakes* case by noting that there was no mark-up over and above the recharge costs, and the fact that the agreement between the entities categorically provided for the payment of value-added tax (VAT) for the arrangement meant that the assessment by the KRA was correct.

## Rethinking staff outsourcing contracts from a tax perspective

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### Comment

This finding begs the question of whether parties should rethink their outsourcing contracts. Generally, the consideration in outsourcing contracts has two distinct elements: the reimbursement of staff costs and a management fee or mark-up. The Tribunal, in *Two Lakes*, had previously determined that WHT should only be imposed on the mark-up or management fees because deducting WHT from salaries could result in the double taxation of salaries that had already been subjected to income tax under Pay As You Earn (PAYE).

In the present case, the Tribunal has determined that in the absence of a clear mark-up and charge of VAT on reimbursement of staff costs, these costs are subject to WHT. In our view, this judgment introduces a risk of the double taxation of staff costs. Where such payments are made to non-resident entities, the risk of double taxation is even greater since the WHT is unlikely to be recovered by the non-resident.

We also note that the Tribunal did not determine the category of management or professional services under which staff secondment services would fall. Under the Income Tax Act (ITA), "*management or professional fees*" refers specifically to payments made for managerial, technical, agency, contractual, professional, or consultancy services. The Tribunal did not make a finding on where staff secondment services fall among these prescribed services. This lack of clarity raises concerns, as simply labeling a payment as "*management or professional fees*" does not ensure it falls under the defined categories for WHT.

The judgment further highlights the VAT implications of staff secondment arrangements. In its decision, the Tribunal noted that the entire staff cost recharges were subject to VAT as consideration for a supply of taxable services. Payments made for staff secondment services may therefore be subject to both WHT and VAT on the gross amount payable, depending on how the secondment contract is worded and a taxpayer's practice is analysed.

### Conclusion

This decision introduces new considerations for businesses with existing secondment agreements or those contemplating such arrangements. It is crucial that these agreements clearly specify the mark-up or compensation due to the company providing the outsourced services. This clarity can mitigate the risk of the KRA classifying the entire reimbursement as subject to WHT. Consistency on the amount subject to VAT should also be emphasised, as VAT should ordinarily apply to the mark-up as opposed to the amount being reimbursed for seconding employees. An invoice for secondment services should demarcate the reimbursement and the mark-up.

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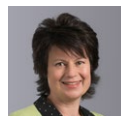
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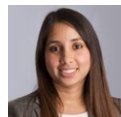
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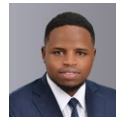
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