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Contract of Service vs Contract for Service

Less than optimistic forecasts on the global economy in general, including even on developing countries, coupled with the recent downgrading of Eurozone countries by rating agencies, have rendered companies very cautious in formulating their business plans for this year. Translated into human resource aspects it would mean tight headcount budgets and needs for flexible human resource plans and arrangements.

Outsourcing and the use of independent service providers have traditionally been common tools to meet such headcount challenges, as they can provide flexibilities for potentially fluctuating business volumes.

This briefing seeks to clarify some key differences between the use of a 'contract of service' and the use of a 'contract for service' by a company (hereinafter referred to as 'the Company').

General Criteria

The fundamental difference is that a 'contract of service' is an 'employer-employee' relationship to hire a staff, whereas a 'contract for service' is a 'client-contractor' relationship to use an independent service provider. The service provider can be an individual or in some cases, an entity under the control of the individual. For the purpose of the Communique, unless otherwise stated, we refer to individual service providers in general.

The parties entering into these contracts have their respective rights and responsibilities under the specific contracts. Under a 'contract of service', the Company provides instructions to an individual employee to personally do specific tasks and carry out specific duties. The employee is generally not liable for damages for wrong doings during the course of his carrying out of the employment duties. In return, the employee is rewarded

with salary, paid holidays, employee benefits, and is also entitled to employment related statutory protection. In China, apart from social insurance contribution obligations, the Company also has individual income tax withholding and other employer obligations.

On the other hand, in the case of an individual serving as an independent service provider, a 'contract for service' sets out a business relationship between the Company and the individual for the purpose of providing such independent service for the Company.

In contrast to a 'contract of service', the independent service provider is responsible for the output of the services as specified under the contract, and is generally liable to make good any damages for wrong doings. The service provider is rewarded by a service fee, and unless specifically restricted, the service provider generally has the ability to assign appropriate personnel to carry out the duties as they deem suitable.

Implications and Tests

From a Chinese legal perspective, a 'contract of service' is subject to the application of the Labour Law, whereas for a 'contract for service', it is within the scope of the civil and economic laws. A 'contract for service' does not need to have labour condition and protection terms.

In China, clarifications by government authorities on the differences between a 'contract of service' and a 'contract for service' are few. Just like other countries, they have primarily been focused on the tax implications. This is because employment income is usually taxed differently from income received for providing independent personal services by an individual. These contracts also have different social insurance and other regulatory implications and compliance obligations.

In an early Chinese tax circular, although focused on individuals from overseas under tax treaties, the key criteria to distinguish independent service provision from an employment relationship is worth taking reference to, in that an individual under a 'service for contract':

1. does not enjoy employee benefits such as medical and social insurance, paid holidays, overseas allowance etc.;
2. is usually paid at regular rates by one time charges, or with reference to hourly, weekly or monthly rates;
3. whose scope of service is fixed or limited, and has responsibilities on the quality of the output;
4. is responsible for incurring expenses related to the service.

For the purpose of the circular, it is also said that if the distinction cannot be made or that relevant terms are not stated in the contract, it will be deemed not to be independent personal service.

In Hong Kong, the attention is also focused on whether a contract for service is 'disguised' employment income, which should be subject to Salaries Tax in Hong Kong. Specific legislation has been promulgated to curb such practices. Under the Inland Revenue's Departmental and Interpretation Notes No 25 (Revised), guidance is provided on the tests to distinguish between a 'contract of service' from a 'contract for service' when applying for an advance ruling (including cases whereby the service is provided by a company under the control of the individual), summarized as follows

1. **Control Test:** who makes decisions, whether there is a fixed place of work, and whether there can be substitutes for the individual etc., are examined to determine whether the individual is controlled by the company;
2. **Integration Test:** whether the individual represents to third parties as a staff, promotion prospects in the Company, and whether it is a continuing relationship etc., are looked at to determine whether the relevant individual is holding a position in the Company;
3. **Economic Reality Test:** who provides the necessary equipment or assistants, how does the individual receive his compensation and the basis of compensation, contract renewal and terms etc., are asked to determine whether the income to the individual is derived from the Company or at his own risk;
4. **Mutuality of Obligation Test:** whether the Company has obligation to pay a wage and provide work, the right to terminate the relationship without liabilities and the individual's obligation to carry out his work or skill etc., are reviewed to determine whether there is mutual obligation between the individual and the Company.

There are other similar tax-oriented legal or referencing clarifications provided by other countries, eg under IR35 of the United Kingdom, which provides similar distinction criteria between the two.

Action

Human Resource Management should be aware of the distinction between an employment contract and a service provision contract, and ensure that appropriate arrangements are in place. What is also important is that such arrangements should be properly included in the appropriate contracts as support, in order to avoid misunderstandings as well as unintentional negligence in discharging regulatory obligations, such as social insurance contributions and tax withholdings.

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