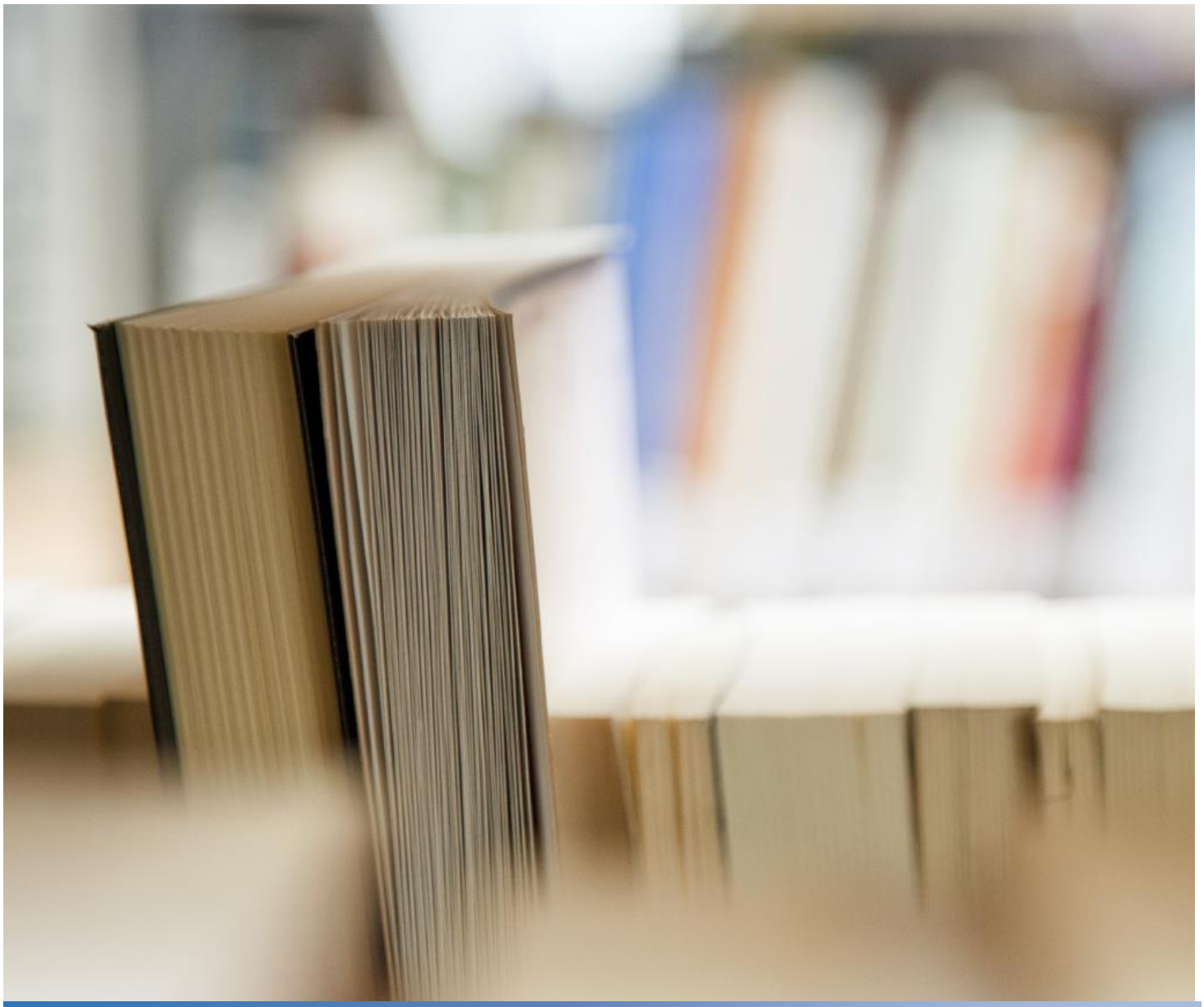

CONUNDRUM OF DIRECTOR'S REMUNERATION IN GST

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Conundrum of Taxability of Director's remuneration under GST

Introduction

The taxability of director's remuneration under GST has caused a furore throughout the country due to a couple of Advance Ruling judgements in case of M/s Alcon Consulting Engineering Pvt Ltd by Karnataka Advance Ruling Authority and the more recent M/s Clay Craft India Pvt Ltd by Rajasthan Authority for Advance Ruling.

First of all, it should be noted that the judgements provided cannot be considered as law of the land and are only binding upon the applicants for their specific cases. Now, upon interpreting the judgment in case of M/s Alcon Consulting Engineering Pvt Ltd, it has clearly been mentioned by the authority in Paragraph 5.1 that the question before the authority does not concern the taxability of director's remuneration and only answers the question of reverse charge mechanism on the same. To this extent, this judgement had a limited scope.

Now upon reviewing the judgement of M/s Clay Craft India Pvt Ltd, it can be easily inferred that the applicant had provided various reasons as to why the directors of the company are to be considered as employees and the GST should not be applicable upon the same. However, it seems that the Hon'ble passed an adverse order without providing the reasons substantiating its verdict and without rebutting the reasons provided by the applicant. In the case of M/s Tata Engineering and Locomotive Co Ltd vs Collector of Central Excise, Pune [2006-TIOL-164-SC-CX-LB], the Supreme Court set aside the order of Tribunal citing the same as cryptic and non-speaking one and justified that the reasons to reach the conclusion is necessarily required to be mentioned in the order. Drawing the same analogy, the order of the Hon'ble Rajasthan AAR can be said to be a non-speaking one as well.

GST Law Provisions

Section 9(1) of CGST Act and 5(1) of the IGST Act 2017 levies tax on intra-state and inter-state supply of goods and/or services respectively. Section 7 which defines

supply also put an exception to the said definition under Schedule III of the CGST Act 2017. As per the said Schedule III, services provided by employee to employer in the course of employment should be considered as neither supply of goods nor supply of services.

Section 9(3) of the CGST Act read with Notification no. 13/2017-CT (rate) dated 28th June 2017 provides that the services provided by the director to the body corporate would fall under reverse charge mechanism. However, the reverse charge applicability would only arise if the director cannot be an employee in terms of Schedule III. Once the director falls outside this ambit, the company paying such remuneration is required to pay taxes under reverse charge. But, if the director turns out to be an employee, then the services provided by him cannot be said to be a supply and would fall outside the coverage of levy of GST. Whether the service provided by the director falls within the ambit of employer employee relationship needs to be examined closely.

Perspective of Companies Act 2013

Types of Directors

A director occupies one of the pivotal positions within the company. He is entrusted with taking decisions as part of the Board which gives direction and future to the company. Some of the directors are also entrusted with managing the affairs and executing the decisions of the Board. They perform dual role – planning for various decisions within the Board and supervising its execution through controlling the affairs of the company on a day to day basis. They can straightaway be considered as executive director of the company. The discussion on this concept has been provided below.

It must be noted that not all the Directors of the company are entrusted with these executionary responsibilities. Some of them are only engaged in providing his professional advisory services and making of policy decisions. They are not engaged in

managing the operations of the company. It cannot be stated that these directors are working under full time employment of the company.

To understand the nature of arrangement of these directors with the company, the Companies Act 2013 have provided various designations to these directors:

a. Executive Director - As per Rule 2(1)(k) of the Companies (Specification of definitions details) Rules, 2014 "Executive Director" means a Whole Time Director as defined in clause (94) of section 2 of the Act". The definition of Whole Time Director as per Section 2(94) of the Companies Act 2013 states that "whole-time director" includes a Director in the whole-time employment of the company. Since the definition of whole-time director is an inclusive definition, the following can be said to be falling within the category of executive directors:

    i. Managing Director – As per Section 2(*54*) of the Companies Act 2013, managing director means a director who, by virtue of the articles of a company or an agreement with the company or a resolution passed in its general meeting, or by its Board of Directors, is entrusted with substantial powers of management of the affairs of the company and includes a director occupying the position of managing director, by whatever name called. Since the managing director is entrusted with the powers of management of the regular affairs of the company, the same traverses beyond the power of a normal director.

    ii. Whole time director – From the definition of whole time director provided above, this director has a dual role – to be a director and a whole time employee of the company. They execute the operations just like a normal employee of the company through his supervision and control by exercising the powers entrusted by the Board.

b. Non-Executive Director – Though this term has not been defined within the GST law, the idea behind this concept can be borrowed from the definition of executive director. These directors generally are not aware of the day to day

affairs of the company but are part of the policy decisions of the company through attendance of board meeting. These directors cannot be said to be in employment of the company.

Non-Executive director also includes the concept of independent director. The definition of independent director as per Section 149(6) of the Companies Act 2013 directly excludes Managing Director, Whole time Director and Nominee Director and provides other conditions for qualification of any other director as an independent director. These exclusions should not qualify as a non-executive director and may be considered in employment of the company.

Contract of employment with MD and WTD

As per Section 190 of the Companies Act 2013, every company is required to keep a contract of employment or service with its Managing Director and Whole Time Director in writing at its registered place of business. If there is no contract in writing, a written memorandum should be present.

The terms of employment suggest (though not conclude) that the MD and WTD of a company should be considered as employees of the company. Further, to fortify and justify the involvement of such directors in the day to day affairs of the company, the contractual terms should justify the employer employee relationship. Certain key clauses are pertinent to prove that the director is an employee of the company which would be discussed in the forthcoming paragraphs.

Key Managerial Personnel and Officers in Default

Upon reading the provisions of Section 2(51) of the Companies Act 2013, the definition of key managerial personnel can be understood. As per the said provision, both Whole time Director and the Managing Director of the company are to be included within Key Managerial Personnel.

Further, Section 2(60) of the Companies Act 2013 suggests that Officers in default would be liable to penalty, punishment through imprisonment or fine etc. These officers in default include the Key managerial personnel of the company.

It can be understood that both MD and WTD can be considered as persons who may be reprimanded for any fault of the company. This points to the direction that the officers who are in regular management and in touch with day to day affairs may only be considered as officers in default. This includes both the MD and WTD of the company.

Number of Companies in which Executive Director appointed

As per Section 203(3) of the Companies Act 2013, a whole time Key Managerial personnel cannot hold office in more than one company except the subsidiary at any one given point of time. This is because an employee cannot work in multiple companies if they are in whole time employment fo the company. Only as an exception, if the consent of all the Directors are obtained, a person may be appointed as Managing Director in the second company.

Thereby, directors who have held the post of executive director in multiple companies and are considering themselves to be employees of these companies may not stand in good stead when required to justify the same to relevant departmental authorities.

Perspective of Service Tax Law

Effective from 7th August 2012, Notification no. 30/2012-ST dated 20th June 2012 had been modified to include services provided by Director under reverse charge mechanism. Further, the taxability of services by director was brought within the Service tax ambit from 1st July 2012 after introduction of negative list. Thereby, two circulars - Circular no. 115/09/2009-ST dated 31st July 2009 and para 7 of Circular no. 354/127/2012-TRU dated 27th July 2012 which have been widely publicized by various sections may not be applicable in the given scenario. Unfortunately, after the introduction of reverse charge on director services under Service tax, no official clarification on the same had been issued under the Service tax law.

However, there have been judicial pronouncements pertaining to the period after August 2012 which have considered the leviability of Service tax on such services.

In the case of Maithan Alloys Ltd vs CCE & ST [2019-TIOL-2737-CESTAT-KOL], it has been provided that remuneration paid to whole time director was pursuant to employer – employee relationship and the mere compensation through variable pay could not alter or dilute the position. The provisions of Companies Act 2013 considering the WTD as officer in default and deduction of TDS under salary within the Income Tax Act 1961 further fortified this position.

In the case of Allied Blenders and Distillers Pvt Ltd) [2019] 101 taxmann.com 462 (Mumbai - CESTAT), the company had paid to four Whole Time Directors for managing day to day affairs and had made relevant deductions for TDS, Professional Tax and Provident Fund. It was held that it was crystal clear from the documents of such statutory authorities that the remuneration paid by the company was in the nature of salary and such directors were only employees of the company.

In Brahm Alloy Limited vs Commissioner Durgapur [2019 (024) GSTL 0616 Tri – Cal], it was held that the Resolution of the company should cover both, the terms of appointment/hiring of the services of the individual and similarly it should also cover that in case of non-performance of the specified duties, the individual shall be fired and/or his appointment would be terminated which should be essential ingredients of the employer employee relationship.

Perspective of Income Tax Law

Within the Income tax return, a person can show the income under the head salaries if there exists an employer employee relationship. Further, while making paying by any company to its employees, it needs to deduct TDS on salary under Section 192. If the company deducts TDS under Section 192 while making payment to a director and that the director the same under the head 'Salaries', it indicates the treatment of the director as an employee under the Income Tax law.

As there are no provisions under the Income tax law for the treatment of a director as an employee under the Income Tax law, the judicial precedents under the said law comes to the aid.

In case of CIT v. [Gira Sarabhai (Smt.) [1994] 209 ITR 356 (Guj.)] Gujarat High Court stated that the nature of a director's employment may be determined by the Articles of Association of a company and the service agreement, if any, under which a contractual relationship between the director and the company has been brought about to check the existence of the relationship of a master and servant.

In the case of Satya Paul vs CIT [1979] 116 ITR 335 (Cal.), it has been stated that if Articles of the company confers a specific right to the company to remove any director before the expiration of his period of office by an extraordinary resolution and if he were so removed he would automatically be dismissed from the office of the managing director, the director could be considered as an employee of the company

Further, Hon'ble Supreme Court in the case of Ram Pershad vs Commissioner of Income Tax [1972 1973 AIR 637], it was held that the Direction in question had to exercise his powers within the prescribed terms and conditions and subject to the supervision and control of the Directors which indicated his employment as a servant of the company. Therefore, his remuneration was to be categorized as salary.

Perspective of ESI law

Definition of employee as per Section 2(9) of the ESI Act 1948 covers within its ambit any person employed for wages within the factory or the establishment for carrying out any work of, incidental or ancillary to that factory or establishment. This does not make any exception for coverage of a director within its definition.

There are quite a few landmark judgements within the ESI law which discusses the role of a director from the perspective of employer employee relationship.

Summarily bringing out the ratio decidendi of Regional Director vs Sarathi Lines (P) Ltd on 29th January 1997 (1998) ILLJ 28 Ker, it was stated that it is true that the Director or

Managing Director are not employees of the company but still these persons could have a dual role – an agent and employee. This is completely dependent on the work and terms of the employment as discernible from the articles of association or terms of agreement. One of the tests laid down was whether under the terms of employment, the employer exercises direct control and supervision control in respect of the work entrusted to the employee.

Further in the landmark judgment of ESI Corporation vs Apex Engineering Pvt Ltd, it was held that the remuneration being paid to the Managing Director under contract of employment pursuant to the resolution of the Board of Directors was due to the extra duties carried by him. He could not be said to be a self-employed person or agent as the ownership belongs to the company and the same is controlled by the Board of Directors. Thereby, Managing Director could not be held as the sole owner. Thereby, Managing Director had a dual role – one as a MD and the other as the servant or employee of the company.

Apart from the above, in the case of ESI Corporation vs Venus Alloy Pvt Ltd [Civil Appeal No. 1464 of 2019 arising out of SLP (Civil) No. 12812 of 2015], the Supreme Court went one step further. It held that the principle held in Apex Engineering applies with a greater force in relation to a director of the company if he is paid remuneration in discharge of the duties entrusted to him. It stated that the Director who had been receiving remuneration should be considered as an employee of the company.

In J.K. Industries Ltd. & Ors. v. Chief Inspector of Factories and Boilers & Ors. [(1996) 6 SCC 665], it was indicated that There is a vast difference between as person having the ultimate control of the affairs of a factory and the one who has immediate or day-to-day control over the affairs of the factory. In the case of a company, the ultimate control of the factory, where the company is the owner of the factor, always vests in the company, through its Board of Directors. The Manager or any other employee, of whatever status, can be nominated by the Board of Directors of the owner company

to have immediate or day- to-day or even supervisory control over the affairs of the factor.

Inferences from the above laws

A director who is not involved in day to day operations of the company as an executive director but his role is simply being part of the Board for attendance during board meetings cannot be considered as employees of the company. His remuneration may be limited to receiving the sitting fees for such attendance during board meetings. His remuneration will be liable to GST under reverse charge mechanism.

In quite a number of small companies, the directors draw significant remuneration more than what they would receive for attending board meetings only but are shown as non-executive directors in the records of the MCA. Further, they are not stated to be whole time director or managing directors in such records. To what extent they are actually involved in the operations of the company may not hold as much significance as the records of the MCA in the eyes of the Department. This may result in the entire remuneration even though in the form of salary to be susceptible to litigation as regards reverse charge under GST. In such cases, it is recommended that the director should immediately be shown correctly in the records of MCA as an executive director with the designation as whole-time director / managing director.

Another important factor contributing towards litigation under GST in respect of director's remuneration is the disclosure under the Income Tax Law. If the company deducts TDS on director's remuneration under Section 194J of the Income Tax Act 1961 or that the Director shows it as part of his income under Business and Profession, then treatment of such remuneration as salary under GST may not be justifiable. Treatment of such remuneration as salary in both the company and director's records along with TDS under Section 192 is imperative for employer employee relationship. Other statutory compliances for employees in the form of Professional Tax, Provident Fund, Employee State Insurance etc. also have a persuasive effect for proving

employer – employee relationship and avoiding GST under reverse charge on director's remuneration.

Even where a director is a whole-time director or a managing director, the terms of employment hold particular significance in order to justify the nature of relationship between the company and the director. To cover most of the bases and justify employer-employee relationship, the following clauses are particularly recommended as part of such terms of agreement:

a. The ultimate control over the affairs of the company will rest with the Board. The MD/WTD should work under the direct supervision and control of the Board of the company.

b. The Board would delegate the management of day to day affairs of the company to the MD/WTD for carrying out smooth conduct of the business.

c. The board would provide the plan, guidelines and policies within which the MD/WTD should act. The execution of these would be the responsibility of the Managing Director.

d. Upon lack of efficient performance of duties by the MD/WTD, the Board has the right to remove such person from his position by passing the Board resolution/upon providing recommendation to the shareholders for passing an Ordinary Resolution.

e. Being the Key Managerial Personnel, in case of any proceedings against the company, the MD/WTD can be held to be the officer in default in terms of the Companies Act 2013.

f. The payment made to the MD/WTD is to be treated as Salary for which the TDS is to be deducted under Section 192 of the Income Tax Act 1961. The payment of Income Tax after considering the other income and deductions under the Income Tax Act 1961 is to be discharged by the MD/WTD himself.

g. The compliances of Professional Tax, Provident Fund, Employee State Insurance etc. as per the applicable laws are to be made by the company as if the payment is being made to an employee.

Thanks & Regards,

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