Employer - Employee Relationship and Service Tax

The Finance Act, 2012 has ushered in a new service tax regime, wherein all the services except those specified in the negative list, have been made taxable. Under the new definition of *service* specified in clause (44) of Section 65B of the Finance Act, 1994, a provision of service by an employee to an employer in the course of employment has been specifically excluded with effect from 1st July, 2012. As a result, the *service* provided by an employee to her/his employer in the course of her/his employment will be liable to service tax, in case an employer and employee, or, a master and servant relationship cannot be established. Here, the author discusses some concerns with regard to the relationship between an employer and an employee. Read on...

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Introduction

Services were first made taxable under the Finance Act, 1994. Until then, a list of 119 taxable services has been defined under the Section 65 (105) of the Finance Act, 1994. Section 143 of Finance Act, 2012 has further amended Chapter V of the Finance Act, 1994 and has introduced a new system of taxation of services, commonly known as *negative list*. In this new system, all services except those defined in *negative list* have been made taxable with effect from 1st July, 2012.

The definition of *service* has been specified for

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the first time in clause (44) of Section 65B under the Finance Act. Service means:

"Any activity carried out by a person for another for consideration, and includes a declared service, but shall not include-

(a) any activity which constitutes merely...;

(b) a provision of service by an employee to the employer in the course of or in relation to his employment;

(c) fees taken in any court;...."

However, the reimbursable expenditure incurred by an employee on behalf of the employer in course of her/his employment would not amount to a *service per se* and, hence, are non-taxable. Now, we will take up certain concerns regarding employer-employee relationship.

How can one ascertain as to whether an employer-employee relationship exists between master and servant or employer and employee?

Employer-employee relationship has not been defined in any particular act or regulation. For determining as to whether any employer-employee, or, master-servant relationship exists between the principal employer and employee, different tests have been advised in various case laws.

1. *In case of Ram Singh and others vs. Union Territory, Chandigarh and others (2004)*, the Supreme Court of India pointed out that, in determining the employer-employee relationship between the principal employer and the contract labour, no doubt, control test is one of the important tests but is not to be taken as a sole test. It is observed that it is necessary to take a multiple pragmatic approach weighing up all the factors for and against the employment instead of going by the sole *test of control.*

   An integrated approach is needed in ascertaining the employer-employee relationship between workers and principal employer. *Integration test* is one of the relevant tests. It is applied by examining whether the person was fully integrated into the employer's concern or remained apart from and independent of it. The other factors which may be relevant are—who is the appointing authority; who is the paymaster; who can dismiss; how long alternative service lasts; the extent of control and supervision; the nature of the job, e.g. professional or skilled work; nature of establishment; and the right to reject.

2. In case of *Silver Jubilee Tailoring House and others vs. Chief Inspector of Shops and Establishments and another (1974)*, the Supreme Court of India pointed out that in determining the fact that 'worker is an employee and not an independent contractor', right to control the manner of doing the work cannot be treated as an exclusive test. *Factors* such as working in the premises of the employer, working on the equipments provided by the employer and power to remove if the work is not in conformity with the instructions are also relevant for determining the relationship.

Thus, for the purpose of determining whether an employer-employee relationship exists in the course of a service provided by a worker to the principal employer, there is no solitary test that can be made applicable under all the circumstances and different tests have to applied depending on the facts and circumstances of a particular case.

Would services provided on retainership basis be treated as services in the course of an employment?

In case a person holds the office in an organisation and receives remuneration by virtue of that office, it does not necessarily bring about a relationship of an employer and an employee or a master and a servant between her/him and the person who paid her/him remuneration. The question with regard to an employer-employee relationship is necessarily a question of fact and that depends on the *nature and characteristic of the appointment or terms and condition of the agreement* between an employer and an employee.

1. The Bombay High Court in an old decision in the case of *CIT vs. Lady Navajbai R.J. Tata [1947]* observed that it was true that a director held an office under a company; he was either appointed or elected by the company. However, every person who held an office need not necessarily be an employee. In the case of a director, there may

be special terms in the articles of association, or there may be an independent contract which may bring about a contractual relationship between the company and the director and constitute the director as an employee of the company; but *independently* of such special contract, a director of a company is not the employee of a company.

2. In the case of *Commissioner of Income-tax vs. Govind A. Swaminathan*, in determining whether *salary* received by the assessee as 'retainer fees' should be assessed under head 'profits and gains of business or profession' and not under the head of 'salaries', the Madras High Court held that it was of the opinion that the principle held in *CIT vs. Lady Navajbai R.J. Tata [1947]* would equally apply in the case of the 'receipt of the retainer fees' by the assessee. The fact that the amount was paid for holding the post was an immaterial consideration, when the assessee received the amount as a person carrying on the profession of an advocate. The receipt was purely a professional receipt. The view of the Tribunal that the retainer fee received by the assessee should be taxed under the head 'Salaries' and not under the head 'profits and gains of business or profession' was not sustainable in law. The Court was of the opinion, that it should be and was rightly assessed under the head 'profits and gains of business or profession' by the assessing officer.

Would a provision of service by a part-time employee to an employer be covered under service tax?

It doesn't matter whether an employee is working on a full-time or a part-time basis. Once an employer-employee or a master-servant relationship is established, the service provided by a worker or an employee would be specifically excluded under the definition of *service*. Thus, for example, an employee works with more than one employer, salaries received from all the employers would not be liable to the service tax.

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Service Tax on Director's Services

Section 66B of the Finance Act, 1994 specifies that service tax shall be levied on all services provided or agreed to be provided in a taxable territory, other than those specified in the *negative list*. As per the new Section 65B (44) of the Act: *service* means *'any activity for consideration carried out by a person for another and includes a declared service but does not include a service provided by an employee to the employer in the course of employment'*.

Thus, a service provided by a director to a company will be subjected to service tax if an employer-employee relationship does not exist.

1) **Consideration paid to directors:** As per Section 309 of the Companies Act, 1956, a company can pay *remuneration* to its directors. It states,
"(3) A director who is either in the whole-time employment of the company or managing director, may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other.
(4) A director who is neither in the whole-time employment nor a managing director of the company, may be paid remuneration — either
(a) by way of a monthly, quarterly or annual payment with the approval of the Central Government; or
(b) by way of commission if the company by special resolution authorises such payment."

2) **Whether remuneration received by a director can be treated as *salary:*** The terms *remuneration* and *salary* have not been defined under the Finance Act, 1994. However, Section 17 of the Income-tax Act, 1961 gives an inclusive definition of the term salary. The Section states:

"For the purpose of sections 15 and 16 and of this section,-(1) 'Salary' includes-
(i) wages;
(ii) any annuity or pension;..."

Therefore, the fact that the term *remuneration* is not mentioned in Section 17 doesn't necessarily mean that the *remuneration* is not *salary*. As per Section 15 of Income-tax Act, 1961, salary is 'paid by an employer' to an assessee. It states:
"The following income shall be chargeable to income-tax under the head 'Salaries'-

(i) any salary due from an employer or a former employer to an assessee in the previous year, whether paid or not; ..."

Thus, if an employer-employee relationship can be established between a director and a company, it can be easily said that the remuneration received by a director is *salary* for the purpose of the service tax and income tax law.

a) In the case of *Income-tax officer vs. Rashmikant C. Patel*, ITAT also held that salary can include remuneration if the employee-employer relationship can be established between a director and the company.

b) In the case of *Gestetner Duplicators (P.) Ltd. vs. CIT [1979],* the Supreme Court of India, while defining the terms salary in the context of a company, observed:
"Salary is payment for the work done or service rendered, made by an employer to his employee, but every person who works for the company is not necessarily its servant. A person who manages the business of a company may be its servant or agent depending on the nature of his service and terms of his employment."

How can one ascertain whether an employer- employee relationship exists between a director and a company?

The employer-employee relationship between a director and a company has not been defined in any particular act or regulation. For deciding the issue as to whether a director could be treated as an employee of a company, different observations have been made in various case laws.

1) In the case of *Ram Prashad vs. CIT (1972),* the Supreme Court of India held that a person engaged to manage a business might be a *servant or an agent*. Though an agent as such is not a servant, a servant is generally for some purposes his master's implied agent, the extent of the agency depending upon the duties or position of the servant. It is again true that a director of a company is not a servant but an agent in as much as the company cannot act on its own but has to act only through its directors who qua the company have the relationship of an agent to its capacity. However a director may have a *dual capacity*. He may both be a director as well as an employee according to the nature of *service* and terms of the employment.

2) In *Sandip Kohli vs. Assistant Commissioner of Income-tax*, the ITAT Lucknow bench held that in order to determine whether the receipt of the income by the full-time director (assessee) from the company was in the nature of salary, it was essential to ascertain whether there existed any relationship of master and servant or employer and employee between the assessee and the company, and whether the assessee was earning 'salary' from the company, as its employee or servant.

For ascertaining whether an employer-employee relationship exists, the assessee working for a company and receiving remuneration for such work should show:

(a) that there was relationship of master and servant or employer and employee between the company and herself/himself,

(b) that such relationship involved the element of *supervision and control* by the employer, that is, the company,

(c) that the *duties or functions* discharged by such a person show that she/he was working as a salaried person and was doing regular work allotted to her/him by the company,

(d) that the remuneration received by him was in the form of salary.

3) In the case of *CIT vs. M.S.P. Rajes (1993)*, the Karnataka High Court observed that the nature of an assessee's employment may be determined by the *Articles of Association* of a company and *the agreement*, if any, under which a contractual relationship between the director and the company has been brought about, where under the director is constituted as an employee of the company. *The control which the company exercises over the assessee need not necessarily be one which tells him what to do from day to day. That would be too narrow a view of the test to determine the character of the employment. Nor does supervision imply that it should be a continuous exercise of the power to oversee or supervise the work to be done."*

In case a managing director has full control over the affairs of a company and holds substantial number of shares, can there still exist any employer-employee relationship between director and the company?

The employer-employee relationship between a director and the company is dependent upon the nature and characteristic of appointment and the terms and conditions or other provisions contained in the memorandum and articles of association.

Case of *Sajid Mowjee vs. Income-tax Officer (2005)*

The assessing officer taking the view that the assessee (full-time director) was having full control over the affairs of the company and he held substantial number of shares as well as paid up capital and therefore, no relationship of employer and employee existed between the assessee, taxed the remuneration received by the assessee under the head *income from other sources*. The High Court of Calcutta held that it was not the character of the recipient but 'the character of the receipt' that is material for the purpose of determining as to under which head the receipt should be treated for the purpose of income tax.

a) *Sections 15 and 17: Scope:* Section 15 enumerates the salaries chargeable to income-tax under the said head. Explanation 2 thereto provides that any salary, bonus, commission or remuneration, by whatever name called, due to, or received by a partner of a firm from the firm shall not be regarded as *salary* for the purpose of the said section. It may be noted that while the explanation included the receipt by a partner of a partnership firm, it did not exclude the receipt by a director from a company, private limited or public limited. Admittedly, a company whether a private limited or public limited is a juristic person. Whether it can be camouflaged or not cannot be questioned so long as it continues to be a company registered under the Companies Act, 1956 either as a private limited or a public limited one, in order to exclude the income under the head *salary* received by an employee or a director as remuneration or commission. As per Section 17(1) (iv), *salary* includes any fees, commission, perquisites or profits in *lieu* of or in addition to any *salary* or wages.

b) *The assessee: Whether an employee:* A company is a juristic person and it is governed by a Board of Directors and is altogether an independent entity other than the Directors. Board of Directors may control the company but such directors might have dual capacity, one as member of the Board as Director and the other as an employee of the company or being in charge of the administration of the company as an independent administrator in the capacity of a Director. The appointment of one of the members of the Board of Directors as full-time Director involved certain kind of responsibility to be carried out in terms of his appointment whether specified or not. The Board has a right to appoint. It has a right to give directions, it may not have a right to take disciplinary action. But it has right to prescribe the conditions of service. It has right to determine the nature of the duties to be performed by the full-time Directors. It has right to determine the *salary* to be paid. Therefore, *the company could be an employer while appointing one of its Director as whole-time Director* on a particular remuneration and prescribing the terms and conditions of his appointment.

Whether a director is an employee or not, is dependent on the nature and character of the appointment and the terms and conditions or other provisions contained in the memorandum and articles of association.

Can a director be employed in more than one company?

For ascertaining whether a director can be an employee of more than one company or not, one has to find out as to whether the relationship of employer and employee exists between director and the company or not.

Case of *Smt. Gira Sarabhai vs. Commissioner of Income-tax (1994)*

The assessee who was managing director of four companies, claimed the remuneration as *salary* and accordingly paid the tax. The ITO treated the same as income from other sources. The High Court held that the answer to the question whether remuneration received by a director is taxable under the head "Income from salaries" or not depends upon the answer to the question as to whether the director is an employee of the company or not. For deciding the question whether a director is an employee of the company or not, one has to find out as to whether the relationship of master and servant exists between the company and the director or not. This question is covered by the decision of this court rendered in the case of *CIT vs. Gautam Sarabhai* [1984] 19 Taxman 353 (Guj).

In the said case, the question was whether the remuneration received by the assessee from Karamchand Premchand Pvt. Ltd. and other three companies was assessable under the head *income from other sources* or as *income from salary*. Following the decision in Income-tax Reference No. 170 of 1976 holding that the assessee was an employee of Karamchand Premchand Pvt. Ltd., the said question was answered in favour of the assessee and against the Revenue. Relying upon the decision in *CIT vs. Gautam Sarabhai [1984] 19 Taxman 353 (Guj)* in Income-tax

Reference No. 200 of 1976 decided on 5th August, 1985, it has to be held by this court that the present assessee was an employee of Karamchand Premchand Pvt. Ltd. and other companies and, therefore, the remuneration received by her as managing director was taxable under the head *income from salary*. In view of the above decision of this court, it could be said that, on the facts and circumstances of the case, the Tribunal was right in law in holding that the remuneration received by the assessee as director from the company was taxable under the head *income from salaries* and not under the head *income from other sources*.

If the remuneration is paid to the directors in the form of commission, bonus, share in profits or ESOPs, would the service tax be applicable in such cases?

Once an employee-employer relationship is established between a director and a company, the remuneration paid in any manner wouldn't change the nature of the service. Thus, in case of the executive directors who are in full-time employment of the company, the remuneration paid in any form is not liable to service tax and, in case there is no such employee-employer relationship, the gross amount paid in the form of commission, bonus, share in profits, ESOPs, etc., would be liable to service tax.

Employer-employee relationship between a director and the company is dependent upon the nature and characteristic of appointment and the terms and conditions or other provisions contained in the memorandum and articles of association.

Who is liable to pay service tax on the director's services?

According to the Notification No. 45/2012-ST, dated 7th August 2012, the provision of service by a director to the company will be covered under reverse charge provisions. Thus, now the company is liable to pay service tax on the director's services. However, for the period between 1st July and 6th August, the directors are liable to pay tax in case their income is more than ₹10 lakh per annum. ■