Payments to Non-Executive Directors-Some perspectives

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The introduction of provisions for deduction of tax at source from payments to directors, application of service tax thereon and the recent circular No. 24/2012 dated August,9,2012 of the MCA have thrown up a number of issues which provide considerable food for thought for the professional fraternity.

During the course of this discussion, we shall discuss some of the issues and endeavour to find a solution to some of the vexatious aspects.

- **Amendments to Section 194J of the Income Tax Act,1961**

Through the insert of clause (ba) to subsection (1) under Section 194J of the Income Tax Act,1961,(hereinafter "The Act") made effective from 1/7/2012 by the Finance Act,2012,the payment of any remuneration or fees or commission by whatever named called other than those payments on which tax is deductible u/s 192 of the Act made to the Directors of a company have been brought into the ambit of deduction of tax at source. The above amendment in the law has set at rest, once and for all, the controversy that subsisted in the professional fraternity for years on the point whether payments of the above genre made to company directors who are not associated with companies in a whole time capacity such as Managing / Whole time directors ,should be subjected to deduction of tax at source. It was argued with considerable force that such payments should be out of the purview of Section 194J considering the fact that the tentacles of the above provision embrace only payments which are for providing ,inter alia, "professional services' within the meaning of the above expression as provided by the Explanation under Section 194J. It was argued that extending services to a Company while acting in the capacity of a Company director did not tantamount to "professional services", having regard to the fact that such service was neither expressly included in the statute within the definition of the above term nor through the extensions given to the definition through notifications issued by the CBDT from time to time through the aegis of Section 44AA of the Act.

Notwithstanding the above, the conservative view advocated was that, one should not be chivalrous in interpreting the law aggressively and hence it would be better to play safe and subject such payments to withholding tax. This view was taken particularly by those who believe in the concept that "discretion is the better part of valour".

Our intention in this exposition is not to revisit the above controversy as the dye has already been cast on the subject through the recent amendments in the Legislation.

- **Amendment made to Section 194J is incomplete**

Before going into the finer points of the law, we would point out, at the outset, that a drafting anomaly has gone apparently unnoticed in Section 194J in the wake of the above amendment brought about by the Finance Act,2012. As stated above, through the insert of clause (ba) to Section 194J payments to non executive directors are now liable to withholding tax. The proviso to Section 194J sets out the threshold monetary limit for the applicability of the provision. Sub clauses (i),(ii),(iii) and (iv) under the proviso stipulate a uniform threshold limit of Rs 30000/ per annum for all payments of such genre which fall within sub clauses(a),(b),(c) and (d) of Section 194J. Clause (ba), ibid, postulates the levy of withholding against payments to Directors. Arising out of the insert of Clause (ba) in the statute, a consequential amendment ought to have been made under the Proviso referred to above in a manner to state that the threshold of Rs 30000/ shall also apply to payments covered by clause(ba) to Section 194J. In the absence of such an express assertion , a conclusion may be drawn perhaps justifiably that every payment to a director contemplated under clause (ba) above, regardless of the quantum would come within the sweep of the law. Drawing such a conclusion would be erroneous in our view, considering that the threshold stated above applies uniformly to all other types of payments embraced by section 194J.We would therefore assert that ,in keeping with the spirit of the legislation that only payments of Rs 30000/ or above in a financial year made to non executive directors should be subjected to withholding. Having said this, it would be appropriate if a suitable clarification is issued by the CBDT leaving no scope for any ambiguity in so far as the applicability of the threshold limit is concerned.

- **Applicability of Service tax on payments to Directors**

Through notification No. 45/2012 -Service Tax dated August 7,2012,which represents an amendment to the Notification

"There is no such thing as gratitude unexpressed. If it is unexpressed, it is plain, old-fashioned ingratitude." - Robert Brault, www.robertbrault.com

No.30/2012-service Tax dated June,20,2012, it has been clarified that the onus of discharging the liability to service tax in respect of services provided by a Director shall lie with the Company under the "revised mechanism charge" a concept which has been introduced in the Finance Act,2012, ostensibly in an endeavour to extend the tentacles of the service tax to almost every conceivable form of service, save and except , certain types of services which are either expressly exempt from service tax or form a part of the "negative list of services" in consequence of which service tax is not payable on services belonging to such genre.

It is ironic that as Service Tax is a levy in the field of indirect taxation as per the accepted canons of taxation it is ordained that the "impact" and "incidence " of the levy should fall on different entities. In respect of certain species of services such as services provided by a person in the capacity of a non-executive Director , both the impact and incidence of the levy fall on the "recipient" of the service. This is a dichotomy in the law, which we have to accept , whether we like it or lump it, as it cuts across the very grain of an indirect tax legislation.

Be that as it may, it follows from the above that as the responsibility to pay the service tax rests with the Company, it has to pay the service tax on the fees/commission on profits regardless of whether the professional Income of the Director concerned exceeds the prescribed threshold of Rs 10 lacs or more in a financial year.. This proposition gives rise to a related question as to whether it is necessary for the Director to whom fees is paid to raise an invoice on the Company towards the sitting fees payable to him.

- **Is it necessary for a Director to raise an Invoice for his fees**

To answer this question , it would be necessary for us to examine the provisions of the Service Tax Rules,1994. Rule 4A of the said Rules, inter alia, provides that the person providing taxable services shall raise an Invoice on the recipient of the Service incorporating therein the details of his registration number ,the description and value of the services rendered ,apart from stating the particulars of the person/entity for whom the taxable services have been rendered.

It is now a settled position that under the reverse mechanism route, as in the case of Directors' fees , the liability of the recipient of the service to pay the service tax remains unchanged notwithstanding that the service provider has not obtained registration under the Rules since his Income from professional services is below the prescribed threshold.. Viewed against the above perspective, it is submitted that it is not necessary for the director extending services to the company to raise an invoice against the payments made to him..

- **Withholding tax on Service tax component of payment to Directors**

Section 194J of the Act having been amended ,Companies are now subjecting to deduction of tax at source the amount paid by way of sitting fees paid to directors @10% of the amount so paid.

The question that immediately springs to mind is whether tax is to be deducted only on the amount paid or on the fees inclusive of the amount of service tax paid thereon by the company. The need to raise this question gains relevance when one considers the contents of Letter F.No.275/73/2007-IT(B) dated 30.6.2008 issued by the Central Board of Direct Taxes(CBDT).In this letter it has been clarified that tax shall be deductible at source on the professional fees u/s 194J inclusive of the service tax component thereon. The above letter is in the nature of a rejoinder to circular no.4/2008 dated April,28.2008 wherein the Department had clarified that TDS shall not be applied on the service tax component of the rental income u/s 194I as the service tax paid cannot be considered as Income of the Landlord.

If the above letter is applied in letter and spirit, Companies may have to consider for withholding tax purposes, not only the fees paid to the director but also the service tax component there on as well.

In our view, holding such a view would not be correct as it would go against the spirit of the Statute. There would be an element of double taxation in the hands of the Company as apart from making payment of service tax , there would be an increase in the quantum of withholding tax as well due to the inclusion of the service tax .

It is submitted that Section 194J postulates that tax shall be deducted at source @ 10% of such <u>sum as income tax on Income comprised therein.</u> (Emphasis supplied). It therefore follows from the above that the service tax paid by the Company on the sitting fees cannot, by any stretch of imagination be considered as the Income of the director. There cannot therefore be a mandate for subjecting to tax the service tax component of the fees paid and the above letter of the CBDT in our view,should be revisited in the light of the application of the "reverse charge mechanism" on sitting fees.

- **Does Service Tax on Directors' payments form part of "remuneration"**

The MCA has by its recent circular No. 24/2012 dated August 9,2012 has, in a manner of speaking ,added grist to the Grind mills by its assertion, inter alia, that service tax paid by a Company on commission paid to Directors shall form a part of their remuneration ,for the purposes of Section 198 of the 56 Act. The circular goes on further to clarify that if ,by the application of service tax on the Directors' commission, the amount payable to the Director exceeds the limits sanctioned by the Members, it would not be necessary for the Company to seek Central Govt. approval for such increase under Sections 309 and 310 of the 56 Act.

This gives rise again to the pivotal question whether Service tax paid by the Company becomes part of a Directors' remuneration.

The term "Remuneration " has been defined inclusively in

"Experience enables you to recognize a mistake when you make it again." - Franklin P. Jones

the Explanation u/s 198 of the 56 Act. The above definition is restricted in application only for the purposes of Section 198,309,310 and 311. Section 309(2) expressly contemplates that a director may receive remuneration by way of a fee for each meeting of the Board or a committee thereof , attended by him.

It is pertinent to reproduce, as under, clause(c) to the Explanation u/s198 for the purposes of our discussion.

"Remuneration shall include:

(c) any expenditure incurred by the Company in respect of any obligation or service, which, but for such expenditure by the company ,would have been incurred by any of the persons aforesaid".

From the above, would it be fair to draw an inference that the service tax paid by the Company along with the fees/ commission that the amount so paid becomes the Directors' remuneration.

To answer this question, we have to look also at certain postulates under the income tax law. It is a settled principle of law that all receipts of an assessee does not always constitute his income. The objective of the Tax law is to tax real income and not income which is sham or illusionary. The concept of "real Income" has been applied by the courts in a number of cases to ensure that what is taxed is as nearly real as possible, given the constraints of Statutory limitations. Income is one which gives the owner disposable capacity. (Emphasis Supplied). Justice Sabyasachi Mukherjee while delivering his leading judgement in *State Bank of Travancore vs.CIT*(158 ITR 102)(SC) laid down some propositions as to what constitutes "real income" of which the following passage is worth reproducing:

"It is the income which has actually accrued or arisen to the Assessee which is taxable. Whether the Income has really accrued or arisen to the Assessee must be judged in the reality of the situation"

We would hasten to add that the above remarks were made in the Judgement in a different context but just the same are relevant for the purpose of deciding the question whether the service tax paid by the company on the fees can really be a part of a Director's remuneration. Our answer to the question is an emphatic no. Firstly, such payment does not lead to any disposable capacity in the hands of the director. Secondly there is no accrual since the amount of service tax has to eventually go to the Govt.Treasury. Even if the service tax were to be paid by the Director subject to reimbursement by the Company (assuming for a moment that the "reverse mechanism charge" were not applicable to Directoral payments), the amount reimbursed by the Company cannot form a part of a director's Income. Therefore all receipts are not taxable as income, more so any payment which is in the nature of a reimbursement. It would be pertinent to refer to the decision of the Madras HC in CIT vs S.Kamalahasan (249 ITR 726) where it was held that an amount received by a film actor on a tour abroad along with his troupe for meeting the tour expenses does not have the character of income and non declaration of the same does not amount to concealment of income.

Fortified by the above judicial pronouncements we reiterate our earlier submission and stick our neck out while opining that the service tax paid by a company to a director cannot be construed as his remuneration. It is extremely essential therefore that the MCA should soon clarify its stand on this issue thus removing the cobwebs of doubt that engulfs the professional fraternity.

Ceiling on Directors' fees under the Companies Act, 1956 (the 56 Act)-Implications of MCA's Circular dated August 9, 2012.

The conclusion drawn by the MCA in its circular referred to above that the service tax paid by the Company shall be deemed to be part of directors' remuneration u/s 198 of the 56 Act has stoked up another controversy. Readers are aware that in terms of Rule 10B of the Companies(Central Govt's) General Rules and Forms ,in relation to Section 310 of the 56 Act , a ceiling has been introduced with effect from 24/7/2003 on the quantum of sitting fees payable to the Directors. In case of Companies with a paid up share capital and free reserves of Rs 10 crore and above or a turnover of Rs 50 Crore and above the sitting fees payable cannot exceed Rs 20000/ per Meeting . For companies not satisfying the above criteria, the ceiling is Rs10000/.

As the above criteria was prescribed some years ago, practically every company of reasonable repute now pays fees of Rs 20000/per meeting.

Assuming but not admitting respectfully that the service tax does form a part of the Directors' remuneration, it is submitted that no longer is there a legal mandate available for a Company to pay sitting fees of Rs 20000/ or Rs 10000/ as the case may be. It will be, willy-nilly, necessary for the Company to prune the amount of sitting fees in a manner that the fees along with the service tax paid is restricted to Rs 20000/ or Rs 10000/ unless the Rule cited above is amended to accommodate the increase arising due to application of service tax. It is understood that some Companies have already reduced the quantum of fees or are alternatively seeking shareholders approval to retain the fees at the existing levels plus the service tax thereon as a conservative measure. The validity of the latter course of action is in considerable doubt as such action would *prima facie*, be beyond the scope of the statute.

We would reiterate our earlier submission and respectfully submit that the MCA should post haste clarify its stand and confirm to the logical proposition that service tax shall not constitute part of Directors' remuneration.

Conclusion

In the course of our above discussion, we may have stirred a hornet's nest as it were. As the conclusion drawn by us above is open to dissent , we would humbly submit that the Powers that be should come out with appropriate clarifications to set right the controversy that is simmering on the subject.

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"Experience has taught me, when I am shaving of a morning, to keep watch over my thoughts, because, if a line of poetry strays into my memory, my skin bristles so that the razor ceases to act." - A. E. Housman