ST on Employers – Draft Circular – Obnoxious Provisions Galore – Oct 30, 2012

OCTOBER 30, 2012

By S Sivakumar

WITH a specific exclusion given only for services rendered by employees to employers and that too, for activities undertaken in the course of or in relation to employment, **services rendered by employers to employees** are in the service tax net with effect from July 1, 2012.

Before we discuss the taxability of services rendered by employers, we need to keep in mind that, the exclusion covers only 'activities' that are rendered by employees in the course or in relation to employment. The PPT issued by TRU talks of the services provided outside the 'terms of employment' being taxable. There seems to be a deliberate attempt on the part of the Finance Ministry to restrict the scope of the exclusion clause of the definition of 'activity', as contained in Section 65B(44), inasmuch as, the exclusion given by the statutory provision talks of activities rendered by employees 'in the course or in relation of employment', which is much wider, as contrasted to the scope of activities rendered by employees 'in terms of their employment'. Take a typical example – a referral bonus paid by the employer to an employee for referring his friend. While this cannot be treated as having been rendered in terms of the employment, this should surely be treated as having been performed in relation to employment. Take another case of an ex-gratia payment made to an employee, let's us say, to meet the expenses on the medical treatment of his wife. Of course, this payment would not form part of the terms of the employment. But, won't this be activity in relation to the employment? Surely so.

The PPT also states that, any non-compete fee paid to an employee, is taxable. Here again…. there is every reason to assume that, no non-compete fee would have been payable, if the payee was not an employee and hence, this payment should be treated as having been made, in relation to employment, as the term 'in relation to' needs to be widely interpreted, in terms of the judicial decisions. A lot of issues would arise on account of the Ministry's attempts to read down the exclusion clause, for sure, providing immense professional opportunities for Advocates and Consultants.

Talking of the exclusion given to services rendered by employees… where does this leave the partners vis-à-vis salaries received by them from the partnership firms? Given that the partnership firm and its partners would be treated as 'different persons' for service tax purposes (not-withstanding the fact that the concept of 'mutuality' is a well-defined and judicially upheld principle under the income tax law) and with partners not being considered as employees, salaries paid to partners by the partnership firms would now be taxable under the service tax law. This could spell a lot of trouble for partnership firms and I am extremely worried about the impact on the CA fraternity, given the fact that, it has a significant number of partnerships. It is another matter that the partnership firm can possibly avail of cenvat credit. This is an obnoxious development which would affect partnership firms and one would expect the Government to exempt salaries received by partners from partnership firms.

With non-Executive Directors being not treated as employees, they would also be treated as service providers, vis-à-vis companies. Commission, sitting fees, etc. paid to non-Executive Directors would now be subject to service tax levy. This again, is an unwelcome development. Take the case of Directors, who are professionals, like Engineers. Under the Companies Act, payment of fees by Companies to Directors, for professional or technical services rendered, is allowed. In these cases also, the Reverse Charge Mechanism

would come into play. That, companies paying service tax under reverse charge mechanism can avail of cenvat credit, is no solace.

Let's now discuss employers being treated as service providers, vis-à-vis employees. The Government has been kind enough to issue a draft circular F.No. **354/127/2012-TRU** dated July 27, 2012, which categorically states that, activities carried out by employers to employees for consideration are taxable, unless specified in the Negative List or otherwise exempted. Any facility or benefit provided by the employer for which, no fee or amount is charged or recovery is made, vis-à-vis the employees, would be outside of the service tax net. Any benefit for which a recovery is made by the employer would be taxable. A typical case would be that of transportation facility, a very common benefit given by companies. How does the employer handle the requirement of having to raise an invoice, in this case? The Government publications state that, the employee, being the service receiver, can avail of cenvat credit of the service tax paid by the employer. It then seems that, the employer is required to raise invoices on each of the employees from whom, recovery towards transportation costs has been effected. Imagine the plight of a large company having thousands of employees and the procedural nightmare associated with the need to raise invoices on each of the employees.
But, what one is really worried about is Para 9 of the Draft Circular, which is reproduced below:

"9. One of the ingredients for the taxation is that such activity should be provided for consideration. Where the employees pays for such services or where the amount is deducted from the salary, there does not seem to be any doubt. However, in certain situations, such services may be provided against a portion of the salary foregone by the employee. Such activities will also be considered as having been made for a consideration and thus liable to tax . Cenvat credit for inputs and input services used to provide such services will be eligible under extant rules. The said goods or services would now not be construed to be for personal use or consumption of an employee per se and rather shall be a constituent to the taxable service provided to an employee. The status of the employee would be as a service recipient rather than as a mere employee when consuming such output service. The valuation of the service so provided by the employer to the employee shall be determined as per the extant rules in this regard ."
It is clear here that the Government is targeting the non-cash components of the Cost to Company ('CTC') packages of employees. As is well known, the CTC is a concept widely used in the corporate sector in general and the IT Sector in particular. Companies follow different methodologies for computing the CTC… many companies allow senior executives to use official cars for personal purposes and also provide a driver and consider a specific amount, towards this facility, which is considered as a 'perquisite' under the income tax law. Now… these amounts, though not recovered by employers from employees, could suffer service tax, in terms of the Draft Circular, if they form part of the CTC. This move is rather unfair, as under the income tax law, these 'perquisites' are treated as part of the salary (though not actually paid to the employees) and charged to income tax. Now, service tax also would have to be paid by the employees on these 'benefits' on the basis that they form part of the CTC. The fallacy here is that the Government seems to be under a totally wrong impression that the employee is legally entitled to the various components mentioned in the CTC package. This is not the case, even under the Income tax law many of these components are not treated as legally receivable by the employee and subjected to income tax. This being the case one does not understand the justification of bringing them under the service tax levy. **Can there be a view that the employee can be regarded as a service receiver for purposes of levy of service tax even when he cannot be treated as the income earner?**
Interestingly, the Draft Circular states that when the employer is levied service tax on activities undertaken for employees cenvat credit can be claimed. One would wonder as to how this could work in a typical situation where, let's say, the employer has hired cars for transporting its employees and is now required to pay service tax on the recoveries made. How does the employer determine the value of services attributable to each employee and accordingly raise an invoice?

Moreover, in the absence of a change in the definition of input service, which specifically prohibits cenvat credit being taken on taxi hire / rent-a-cab services except in cases where motor vehicles are used as capital goods, cenvat credit would still be denied to employers, despite that, they are liable to pay service tax on the

recoveries made from employees. This would add to the cost of operations for corporates who have employee welfare schemes such as subsidized transportation, etc.

Before parting …

One does not know the quantum of the service tax (net of cenvat credit) that the Government would ultimately collect by levying service tax on employers and employees. The move to levy service tax on employers reminds one of the obnoxious levy of income tax on corporates, on fringe benefits, which brought a lot of criticism and which had to be ultimately withdrawn . The Finance Ministry would do well to understand and appreciate that companies would have to incur significant compliance costs, vis-à-vis service tax on employer-employee transactions and this would result in a great deal of negativity, especially, vis-à-vis the foreign companies and investors.

The FM, who has pledged to simplify tax laws, would do well to completely exempt transactions between employees and employers and vice-versa, from the levy of service tax. The only beneficiaries vis-à-vis this obnoxious levy would be the Advocates, CAs and theConsultants, given the voluminous litigation that would follow.