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Director's liability under the Income tax law – An insight

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It may be enticing to hold a directorship position in a corporate house. However, should the roofs descend someday, it becomes equally undesirable. The same tag potentially becomes an albatross around the neck. In such scenarios, while the liability of a shareholder is limited to the sums invested in the company or the sums agreed to be invested, in certain instances, the liability of a director can become unlimited. The fiction of 'separate legal entity' of a corporate form, sometimes, by legislation to contrary, does very little to shield the men and women behind its veil. Legislations in India impose various liabilities on the director for any wrongdoing by a company, fairly enough, since those at the helm of decision making cannot be left scot-free, leaving government remediless.

The Income Tax Act, 1961 ('IT Act'), vide Section 179, imposes joint and several liabilities on every director of a private company[1] for recovery of tax dues, should the same not be recoverable from the hands of the company. Upon the section becoming applicable, the directors would step into the shoes of the company as an Assessee for the purposes of payment of all taxes due under the IT Act from the company[2]. Thereafter, the provisions of the IT Act, specifically, those relating to recovery would apply on the director as they were applied on the assessee company.

Such a provision was introduced for the first time in the IT Act, from 1st April, 1962, there being no *pari materia* provision present in its predecessor legislation.[3] When the section was first introduced, it was only made applicable to companies that were being wound up, in that, only directors of companies that were liquidated were covered by the Section. With effect from 1st October, 1975[4], applicability of the section was extended to all private companies in scenarios where recovery of tax demands against such companies did not yield results. This Article addresses certain aspects relating to liability of directors under the IT Act.

a. Scope of the section - public company v. deemed public company v. private company

From a plain reading of Section 179 of the IT Act, it appears that directors of public companies are not covered by the rigors of the section. Even companies that are deemed to be public companies under the Companies Act[5] would be outside the purview of application of Section 179 of the IT Act[6]. However, where the affairs of a company, incorporated as public limited company are arranged in such a way so as to defraud the revenue and the surrounding circumstances merit disregarding the legal structure, then, the Income tax authorities would have the power to lift the corporate veil and treat the directors of such a company as liable under Section 179 of the IT Act[7]. With the enacting of anti-avoidance

[1] As defined in Section 2(68) of the Companies Act, 2013.

[2] Section 2(7) of the Act defines an assessee to mean a person by whom any tax or any other sum of money is payable under this Act

[3] The Indian Income Tax Act, 1922

[4] Taxation Laws (Amendment Act), 1975

[5] The Companies Act provides that any private company that is a subsidiary of a public company will be deemed to be a public company.

[6] *M.Rajamoni Amma* v. *Dy CIT* [1992] 195 ITR 873 (SC); *Suresh Narain Bhatnagar* v. *ITO* [2014] 367 ITR 254 (Guj)

[7] *Ajay Surendra Patel* v. *DCIT* [2017] 394 ITR 321 (Guj.)

provisions[8] in the statute, such a power now flows to the Income tax authorities, from the provisions of the statute itself.

b. Who can be made liable?

The liability under Section 179 will lie on every person who was, at any point in time, a director of that company for the previous year in respect of which the taxes are sought to be recovered. To illustrate, if Mr A was a director during the financial year 2018-19, and additional tax demand in respect of that financial year is raised pursuant to a tax assessment that is completed in 2021, Mr A can be held liable under Section 179, even if he had resigned from directorship in 2020. Further, even those individuals who have resigned from directorship during the relevant previous year or those individuals who were inducted into the directorship during the year would be covered by the provision. The provisions would equally apply to nominee directors or directors appointed by interested parties like lender/ technology partner, etc.

c. When would the liability trigger?

Suffice it is to say, that the directors' liability would get triggered only in scenarios where the Income tax authorities establish that attempts made to recover from the company have gone in vain[9]. Where no attempt was made to recover the tax due from the debtors of and shares held by the company, it was held by the Hon'ble Allahabad High Court that seeking to make the director liable under Section 179 of the IT Act would not be valid.[10]

It is also to be noted that private contracts would not override the statutory requirement. The Managing Director assuming all responsibilities under section 179 of the Act in a contract with the other directors will not absolve the directors from liability under the section. The Revenue Authorities will have recourse to recover the tax dues from all the directors, irrespective of the agreement amongst them.

d. Section not to apply when duty performed with due diligence

The charge created on the directors vide Section 179 is however, not sacrosanct, in that, should any director be able to demonstrate that non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to affairs of the company, then, there will not be any liability cast on the director. Needless to say, this would depend largely on the surrounding facts and circumstances of the case and the factors giving rise to the demand of tax. Though the responsibility to establish that the non-recovery of dues from the company cannot be attributable to the gross neglect, misfeasance or breach of duty by the director is on the director himself[11], the Gujarat High Court[12] had held the Revenue Authorities hold an equal responsibility to prima facie form a belief that the non-recovery is attributable to the gross neglect, misfeasance or breach of duty by the directors[13].

The section, strangely, does not restrict its applicability to directors in charge of accounting or finance, but casts the net wide. The Hon'ble Gujarat High Court[14] held that merely because an individual is a technical director, that would, *ipso facto,* not mean that liability cannot be enforced on that director under Section 179 of the Act. It is imperative on every director to establish that there was no gross neglect, misfeasance or neglect of duty on this part. Even director who is

[8] Anti-avoidance provisions are contained in Chapter XA of the Act
[9] *Madhavi Kerkar* v. *ACIT* [2018] 403 ITR 157 (Bom.)
[10] *Smt.Prathiba Garg* v. *CIT* [2014] 264 CTR 520 (All.)
[11] *M.R. Sundararaman* v. *CIT* [1995] 215 ITR 9 (Mad.)
[12] *Ram Prakash Singeshwar Rungta* v. *ITO* [2015] 370 ITR 641 (Guj.)
[13] It may be noted that order making a director liable under Section 179 is not an appealable order
[14] *Suresh Narain Bhatnagar* v. *ITO* [2014] 367 ITR 254 (Guj.)

a foreign citizen can be held liable under the section.

However, where the recovery of taxes from the company was impossible due to the assets of the company being under the possession of lender,[15] or where civil disputes relating to recovery of dues of the company are pending before judicial forums,[16] a director cannot be held liable for non-recovery of taxes of the company.

e. Sums that can be recovered - 'tax due' meaning of

Another interesting aspect to note is that the provisions Section 179, until its amendment vide Finance Act, 2013, did not contain any definition for the term "taxes due". In the absence of definition for the term "taxes due"[17], the Courts opined that the director's liability is limited only to income tax due and that it cannot extend to interest and penalty[18]. To plug this loophole, the Finance Act, 2013 amended the Section to include a definition of the term "taxes due". Taxes due, with effect from 1st June, 2013[19] includes penalty, interest and any other sum due under the Act. It is pertinent to note that there was no express retrospective application of the said amendment. A question that needs to be deliberated here is whether this amendment will apply for qua any orders passed after that date or whether this amendment would apply only with respect to assessment years after that date i.e AY 2014-15 onwards.

In a question before the Hon'ble Kerala High Court[20] on whether Section 179 would have application for previous years prior to coming into force of that Section and when no *pari materia* provision existed in the predecessor legislation, it was ruled that no liability under Section 179 can be invoked on the directors for any previous year prior to coming into force of the Act of 1961 from 1st April, 1962.

When Section 179 was amended with effect from 1st October, 1975 to include all companies and not just companies that are wound up, a question arose before the Hon'ble High Court of Calcutta[21] as to whether director of a company that is not in liquidation during assessment years 1968-69 to 1974-75 can be fastened with liability to pay tax. The Court answered in the negative and held that no liability would arise on the director, absent retrospective effect given to the Section, for financial year 1974-75 or any earlier year. A different view was, however taken by the Bombay High Court, which held the amendment from 1st October, 1975 would have a retrospective application. The Court ruled so upon a combined reading of subsection (1) and (2) to Section 179[22] and held that while provisions of sub-section (2) were expressly made applicable from 1st April, 1962, one cannot, sans harmony read that sub-section (1) would operate only prospectively. That ruling by the Hon'ble High Court of Bombay was weighed, therefore, by the specifics of the amendments made with effect from 1st October, 1975.

It is an accepted principle that the law that exists on the beginning of the Assessment Year would prevail for making assessment qua that

[15] *Jashvantal Natverlal Kansara* v. *ITO* [2014] 367 ITR 254 (Guj.)
[16] *Gul Gopaldas Daryani* v. *ITO* [2014] 367 ITR 558 (Guj.)
[17] The term "tax" is defined in Section 2(43) of the Act to mean income tax and super tax chargeable under the provisions of the Act.
[18] *Maganbhai Hansrajbhai Patel* v. *ACIT* [2013] 353 ITR 567 (Guj.); *Hemendra Sakarlal Gandhi* v. *ITO* [2013] 216 Taxman 98 (Guj.)
[19] Memorandum to Finance Bill, 2013 specifies that this amendment will take effect from 01.06.2013

[20] *Ratanlall Murarka* v. *ITO* [1984] 145 ITR 433 (Bom)
[21] *Smt. Bidya Devi* v. *CIT* [2000] 113 Taxman 378 (Cal)
[22] *UoI* v. *Manik Dattatreya Lotlikar* [1987] 35 Taxman 526 (Bom)

year. Section 179 is in itself a charging section that creates liability on the directors for tax dues by a company. Earlier such a liability was existing only qua the tax component and it was only by an amendment from 1st June, 2013 that it has been extended to levy of penalty and interest as well. This amendment has not been expressly made retrospective and has been expressly made applicable only from 1st June, 2013. Section 179 is also not like provisions of tax deducted at source which are transaction based and can apply from any given date. As such, it is not only logical but also within the spirit of law, to interpret that the Section would apply only qua assessment years that begin on or after 1st June, 2013 i.e. only from AY 2014-15.

f. Precautions to be taken by directors

Therefore, as already stated, proving the director as not liable under Section 179 would largely depend on the facts and circumstances of case. But, such reasons need to be built after identifying the reasons that have led to the company's financial position and after analysing the underlying causes that give rise to tax demand. The extent of actual participation by the director in decision making, the assent or dissent given for any resolutions at the Board meeting and the specific roles and responsibilities assigned to and actually carried on by the Director would be relevant. It should be kept in mind that what is required to be demonstrated is the fact that the *non-recovery* was not due to gross neglect, misfeasance or breach of duty on part of director. Therefore, identifying the factors for the inability of the company to not pay the tax dues and addressing the same would be crucial.

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Circular

Form 3CD: CBDT defers reporting requirement on GAAR and transaction with GST registered /non-registered entities

Form 3CD (tax audit report) was amended by Notification dated 20-7-2018 to include reporting of whether the assessee has entered into an impermissible avoidance agreement (under GAAR) under Entry 3C as also particulars of expenditure relating to entities registered under GST and relating to non-registered entities. However, the reporting requirements were kept in abeyance till March 31,2019. By way of Circular No.9/2019, dated 14-5-2019, it has now been extended to March 31, 2020.

Ratio Decidendi

Performance incentive is not a statutory bonus and deduction can be claimed for provisioning

The Assessing Officer had disallowed deduction of the amount of performance incentive payable to the employees on the ground that it had not been paid as was required in terms of Section 43B and that the amount had not crystallised in the relevant financial year. The ITAT held that Section 43B is applicable for bonus payable under a statute like Payment of Bonus Act and the expense in question was in the nature of salary. Further, as per the terms of employment, the employee was eligible for annual bonus. Hence the said amount would be allowable as an expense in the mercantile system of accounting as part of salary payable. [*Harita NTI Limited* v. *DCIT* - ITA 2114/Chny/2017, Order dated 30-4-42019, ITAT Chennai]

AMP expenses incurred by assessee is an international transaction requiring separate benchmarking

Assessee was engaged in the business of manufacturing and distribution of liquor with brand name 'Bacardi', owned by AE. During the year under review, assessee had incurred substantial AMP expenses. Assessee received reimbursement for certain portion of AMP expenses in accordance with global decision. For other portion of AMP expenses, assessee claimed the same have been incurred for the promotion of its own sales in India.

The question before ITAT was whether AMP expenses incurred by the assessee (whether reimbursed or not) is an international transaction requiring benchmarking? ITAT held AMP expenses as an international transaction relying on the below facts:

- Global level marketing strategies were decided and planned, even at the local level marketing strategies were within the global framework of Bacardi Group;
- There was no separate agreement between taxpayer and its AE to ascertain the extent to which AE will reimburse the expenses. Also, there was no segregation of AMP function for which amount is recovered from AE, only common function of AMP is performed.
- Website and newspaper content supported that assessee is building the brand of Bacardi products owned by its AE
- Decision in the case of *Goodyear* was distinguished owing to the facts that in the case of *Goodyear* Assessee was a manufacturer and in the present case there was distribution as well as manufacturing of products bearing AE's brand. [*Bacardi India Pvt. Ltd.* v. *DCIT* - TS-233-ITAT-2019(DEL)]

'Multiple' counting of employees in a single day impermissible while construing service PE threshold

Assessee was a tax resident of UK and was engaged in the practice of law. The assessee had not opened any branch office in India. It was appointed as a legal advisor for some of the projects in India for providing legal consultancy services to them. For the provision of services in India, lower tax authorities held that Assessee had service PE in India as per Article 5(2)(k)(i)of the India UK DTAA, as the period of stay of employees exceeded 90 days in 12 month.

Question before Tribunal was with regard to counting of number of days for the purposes of service PE. The assessee contended that for counting number of days, period for which an employee of assessee was on vacation and did not perform any services for the assessee should be excluded. ITAT held in favour of the assessee after detailed verification of the facts, to conclude that employees were actually on leave and did not perform any services for the Assessee during such period. The assessee also contended that multiple counting of employees in a single day is not permitted. ITAT held that the stay of employees in India on a particular day has to be taken cumulatively and not independently. Multiple counting of days in a single day is impermissible under Article –5(2)(k)(i) of India–UK Tax Treaty. Since, excluding the above period, as employees of Assessee rendered services in India for a period of less than 90 days, ITAT held that no services PE is constituted and thus the addition made is to be deleted. [*Linklaters* v. *DDIT* - TS-210-ITAT-2019(Mum)-Linklaters]

Immovable property representing share in partnership transferred to retiring partner on reconstitution not taxable

The assessee - a partnership firm underwent a reconstitution and two partners retired. At the time of reconstitution, the assets and liabilities were valued and allotted among retiring and continuing partners. The department contended that capitals arose on transfer of assets to retiring partners and the same was taxable in the hands of the firms in terms of Section 45(4) of the Income Tax Act, 1961. The said section seeks to tax profits arising from transfer of capital asset by way of distribution of capital asset on dissolution or 'otherwise'. According to the revenue department, the terms otherwise included reconstitution of the firm. The assessee argued that the retiring partners did not receive any consideration for the transfer, there was no transfer of interest in favour of continuing partners and the asset has been received in lieu of the retiring partner's interest in the firm. The High Court of Madras agreed with the assessee and held that Section 45(4) would not apply in the present case. [T.C.A 265/2009 and Ors., Judgement of High Court of Madras dated 8-4-2019]

Deeming fiction created under Section 50C has to be given full effect to while computing capital gain (u/s. 45) and amount of exemption (u/s. 54EC)

The assessee was a joint owner of a plot of land. The plot was transferred in favour of the purchaser for which assessee received 25 Lakhs. Assessee invested entire consideration in the bonds as specified in section 54EC and claimed full exemption from capital gain. The stamp duty value of assessee's share was computed as 76.17 Lakhs which was also considered as full value of consideration by the AO for computing revised capital gain. While computing the revised capital gain AO allowed exemption u/s 54EC of actual amount invested in bonds. Assessee contended that as full amount received by it has been invested in bonds, no capital gain should arise under section 45. The deeming fiction given under section 50C would have no applicability for the purpose of section 45 and section 54EC.

The High Court held that deeming fiction of treating stamp duty value as the full value of consideration for the purpose of section 50C must be given full effect. Accordingly, computation of capital gain and exemption under section 54EC shall have to be worked out on the basis of substituted deemed sale consideration sale consideration. [*Jagdish C. Dhabalia* v. *ITO* - [2019] taxmann.com 208 (Bombay)]

AMP expenditure incurred in case of an independent distributor not considered as separate international transaction

Assessee was a wholly owned subsidiary of CASIO Japan and was acting as an independent distributor of CASIO products in India which were manufactured by its parent company. Assessee had incurred significant AMP expenditure, which in view of tax officers was incurred for the promotion of brand name of the parent company and thus, amounts to separate international transaction. The view of tax officer was strengthened from the fact that Assessee in the earlier assessment year had entered into agreement with AE (for a 6 month period) for carrying local advertisement of CASIO products in India. Tax officer applied Bright Line test for benchmarking of AMP transaction.

The issue before ITAT was whether AMP expense should be considered as a separate international transaction requiring benchmarking. On the basis of function asset and risk (FAR) analysis of the Assessee, it was clear that Assessee was acting as an independent risk bearing distributor in India. Thus, it was solely responsible for sale in India and was incurring AMP expenses for promoting its own sale. The agreement for preceding year relied upon by tax officer for concluding AMP as international transaction cannot be inferred as it was for preceding year and that too only for part of year. The tax officer failed to bring on record any material or arrangement to between assessee and its AE to support that separate international transaction of AMP exist. According to the ITAT any kind of AMP expenditure cannot be treated as being incurred for brand building of AE. Increased AMP expenditure should be attributed to enhancing sales in India which would benefit the exploiter of the brand. In the instant case, the benefit to the brand owner was only incidental. Also returns for exploitation of intangible could not be attributed to the legal owner who only owns title and does not perform adequate FAR. Thus the ITAT held that AMP expenditure cannot be treated as a separate international transaction. [*CASIO India Co. Pvt. Ltd.* v. *DCIT* - TS-341-ITAT-2019(DEL)]

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