

TAXATION: Personal Liability of Company Directors

I propose to examine the following three areas in taxation as it relates to company directors.

1. The answerability of a director for the tax affairs of a company.

2. The answerability of a company director as an employer for the enforcement of the P.A.Y.E (Pay as You Earn) scheme of tax collection.

3. The liability of a director as an employee to taxation of profits from employment.

For this purpose it is relevant and useful to see how tax law and company law identify a director of a company. The following statutory definitions are helpful.

i) The Inland Revenue Act No 28 of 1979 does not contain a statutory definition of a company director. Sections 146 (1) and (2) refer to the “principal officer of every company” and includes at director in the term “principal officer” together with a secretary or a manager of a company.

ii) A company director or a director of a corporation is also included in the statutory definition of “executive officer” in section 163 of the Act.

“Executive officer” means a director of a company or corporation and any employee in any trade, business, profession or vocation, whose monthly emoluments (including all allowances) are not less than five thousand rupees. (Amendment Act No. 8 of 1988).

iii) Section 449 of the Companies Act No.17 of 1982 contains the following definitions:

“Director” includes any person occupying the position of director by whatever name called.
“Officer” in relation to a corporate body includes a director, manager or secretary.

iv) For the purpose of PAYE scheme of tax collection, section 113 of the Inland Revenue Act includes any director of a company in the definition of “employee” and also includes a secretary, manager or other principal officer of a company or body of persons. Therefore for purposes of taxation of profits from employment, a director of a company is an employee and for purposes of fixing responsibility for deduction of P.A.Y.E. tax from the remuneration of employees of a company, a director is also an “employer”.

It will be seen that the above statutory definitions identify the legal position of a company director. This position has been explained as follows:

“As a company has no physical but a legal existence, the management of its affairs is entrusted to human instruments called ‘directors’ whose exact position in relation to the company is rather hard to define. Directors as such are no servants of the company, but are rather managers who in some respects may be said to be quasitrustees or fiduciaries and agents for the company. The result is that they owe fiduciary duties and certain duties of care to the members of the company”. (Charlesworth’s Company law on page 338, 13th edition).

The following judicial dictum is also helpful.

“The directors are the trustees or the agents of the company trustees of the company’s money and property – agents in the transactions which they enter into

on behalf of the company". *(per Lord Selborne L.C. in Great Eastern Railway Co. v. Turner (1872) L.R. 8 Ch 149 on p.152.)*

The vicarious liability imposed on a company director as it's principal officer by the Inland Revenue Act appears to be based on these concepts.

1. The answerability of a company director for the tax affairs of the company

(a) Section 146 (1) of the Inland Revenue Act No. 28 of 1979 states as follows:



The secretary, manager, director or other principal officer of every company or body persons, Corporate or incorporate shall be liable to do all such acts, matters or things as required to be done under the provisions of this Act by such Company or body of persons… Provided that any person to whom a notice has been given under the provisions of this Act on behalf of a company or body of persons shall be deemed to be the principal officer thereof, unless he proves that he has no connection with that company or body of persons or that some other person resident in Sri Lanka is the principal officer thereof (the Turnover Tax Act no. 69 of 1981 contains similar provisions. Vide section 24 (1) and 24 (2).

This provision imposes vicarious liability on a company director but this liability is limited. For instance,

• An assessment to tax on the company cannot be made on a director, since the company is a distinet legal entity and assessable as such; thus a notice of assessment which states “XYZ Managing Director, for AB Company Ltd”, is not a valid notice of assessment, since a director is not vicariously liable in law for the taxes of the company. which is the assessee chargeable to tax and from which the taxes can be recovered.

• The deeming provisions of the provisons to section 146 (1) are very wide and enable the Revenue Department to give a notice to any person on behalf of a company. A notice in this context, is not a notice of assessment, assessing the company to income tax or any other tax. There is a presumption in the section that any person to whom a notice has been given is the principal officer (which includes a director). But this can be rebutted by proving that the person to whom the notice has been given has no connection with the particular company or that some other person resident in Sri Lanka is the principal officer. For example, a director can prove that the
managing director and not a director is the principal officer.

• Section 146 (1) does not empower the Revenue Department to recover taxes assessed on the company from a director who is the principal officer by invoking recovery measures against that director. The legal effect of section 146 (1) cited above has been considered in the landmark decision of Gratiaen J. in M.E. de Silva v. Commissioner of Income tax (Ceylon Tax Case Vol. 1 at p. 410 and 53 N.L.P. 280) and also in a comparatively recent decision of G.P.S. de Silva J. in Rajan Phillip v. Commissioner-General of Inland Revenue (Court of Appeal Application No. 1174/81 decided on 8 April 1982).

• Section 146 (2) of the Inland Revenue Act No 28 of 1979 imposes vicarious liability on the director of a company as its principal officer for tax offences committed by the company, i.e. any of the penal offences enumerated in Sections 151 (1); 151 (2); 151 (3); 151 (4): 151 (5); 153 (1); and 153 (2). (Default in payment of tax assessed on the company is not an “offence”).

These offences may be summarised as follows:

1) Failure to comply with statutory notices.

2) Failure to deduct P.A.Y.E. tax and failure to comply with the provisions of Chapter XV of the Act relating to the enforcement of P.A.Y.E. tax.

3) Furnishing incorrect returns by omissions or understatements of income.

4) Furnishing incorrect returns by false claims for deductions or allowances.

5) Making incorrect declarations by omitting or understating the remuneration of any employee or the amount of tax deducted from the remuneration of an employee.

6) Committing any act of tax evasion such as wilful omission of income from returns, signing false statements of returns giving false information or answers in reply to Revenue queries, preparing and maintaining false books of accounts or other records or falsifying or authorising the falsification of such books of accounts or records, making use of or authorising any fraud, act or contrivance.

The above mentioned sections of the Inland Revenue Act provide for heavy penal sanctions including fine or imprisonment or both fine and imprisonment after summary trial before a Magistrate. Although the offence is said to be committed by the company, guilt of the offence is attributed to the principal officer of the company.

This vicarious liability imposed on a director of a company as its principal. officer may however be rebutted by proof that the offence was committed without his knowledge and that he exercised all such diligence to prevent the commission of that offence as he ought to have exercised, having regard to the nature of his functions in such capacity and to all other circumstances. The following criteria laid down by the courts may be helpful in the defense to a charge under section 146 (2):

I) A director is not liable for a mere error of judgment, provided that he has acted within his powers, and his act does not constitute negligence or a breach of his fiduciary duty. He is not expected to be an expert in the company’s business and does not incur any responsibility for any mistakes which occur solely because of his ignorance of that business. (Re Brazilian Rubber Plantations and Estates Ltd. (1911) 1 ch 425).

II) A director is liable for negligence if he fails to exercise the standard of care required, from him. But this standard is not unduly onerous being of no more than may reasonably be expected from a person of his knowledge and experience. (Re City Equitable Fire Insurance Co. Ltd. (1926) Ch 407 CA).

III) A director is liable for any misfeasance if he fails to act honestly or in the interest of the company as a whole.

IV) The Companies Act 1985 of England empowers the court in any proceedings against an officer of a company (which includes a director) for negligence, default, breach of duty or breach of trust, to relieve him wholly or partly where the court is of the opinion that he has acted honestly and reasonably and ought in all the circumstances of the case, including those of his appointment to be excused. (Section 727).

This vicarious liability imposed on a director of a company as its principal officer may however be rebutted by proof that the offence was committed without his knowledge

V) Appropriation of profits and income of a company by a director. Where the profits and income of a company for any year of assessment or any part of such prof its and income are appropriated by any director, manager, shareholder or executive officer of that company, such profits and income or such parts of such profits and income shall form part of the profits and income for that year of assessment of the person by whom such profits or income or part thereof are appropriated and shall be assessable accordingly, and the Commissioner-General may take into account all the circumstances of the case, deduct such profits and income or part thereof under section 23 (1) for the purpose of ascertaining the profits and income of that company for that year of assessment. (Section 40- Inland Revenue Act No.28 of 1979).

This provision does not exist in the law prior to 1979 and appears to be a departure from the principles adopted by the British Courts in deciding cases of appropriation of the profits and income of a company by its directors.

2. Answerability of a director who is an em ployer under the P.A.Y.E. scheme

These obligations may be summarised as follows:

1) To issue Employees Declaration forms by the specified dates and whenever an employee makes a request.

2) To maintain a pay sheet in the prescribed form for each liable employee. Non-

compliance with the above obligations will:

a) result in the failure to deduct and remit to the Department of Inland Revenue the correct amount of tax on the salaries and wages of the company's employees,

b) result in prosecution and on conviction to a fine and /or imprisonment.

3) To deduct the correct amount of tax from the remuneration paid to employees liable to income tax and to remit the tax deducted in any month before the 15th day of the month immediately following. Non-compliance with this requirement will result in the following:

a) A director (employer) will be personally liable for such tax as was deductible but not deducted and for that amount of tax that was deducted but was not remitted.

b) A director can be assessed by an assessment estimating the amount of tax was deductible and payable.

c) A director may render himself liable for prosecution.

d) A director will incur the automatic penalties arising on default of payment upto a maximum of 15% of the deductible and assessed.

4) To furnish a monthly declaration and also an annual declaration. Non-compliance will result in an assessment being made on the director. He will also render himself liable to a penal prosecution.

5) To forward to the department, the income tax deduction cards.

6) To issue certificates of income tax deduction to employees of the company from whose remuneration tax deductions were made.

7) To make adjustments before tax is recovered from employees in accordance with directions obtained from and issued by the Inland Revenue authorities.

8) To keep in safe custody employees' declarations, pay sheets of directors and documents relating to the remuneration paid to employees and P.A.Y.E. tax deductions.

9) To permit any authorised officer of the Inland Revenue to inspect the above

mentioned records and documents.

10) To obtain prior approval from the commissioner if the employer wishes to maintain his own form of pay sheet for the operation of the P.A.Y.E. scheme.

Non-compliance with 5,6,7,8,9 and 10 above will render the employer liable to prosecution and penal sanctions

3. The personal liability of a director as an employee to taxation of profits from employment

This liability is governed by sections 4 (a), (b), (c) and (d) of the Inland Revenue Act No 28 of 1979, which are a follows:

Section 4A: (1) Profits from any employment include: any wages, salary, allowance, leave pay, fee, pension, commission, bonus, gratuity, perquisite or such other payment in money which an employee receives in the course of his employment.

(ii) The value of any benefits to any employee or to his spouse, child or parent including the value of any holiday warrant or passage.

iii) Any payment to any other person for the benefit of the employee or of his spouse, child or parent, whether received or derived from the employer or others.

Section 4B: The value of any conveyance granted free of any charge by an employer to any employee, or any sum so granted for the purchase of any conveyance.

Section 4C: (1) Any retiring gratuity or any sum received in commutation of pension.

(ii) Any sum paid from a provident fund approved by the Commissioner-General to any employee at the time of his retirement, other than such part of that sum as represents his contributions to that fund made after April 1, 1954.

(iii) Any sum paid from a regulated provident fund to an employee other than:

(a) such part of that sum as represents his contribution to that fund; and

(b) such part of that sum as represents the contributions made by the employer to

that fund prior to April 1, 1968 and the interest which accrued on such contributions, if tax at the rate of fifteen percent has been paid by such employer in respect of such contributions and interest.

(iv) Any sum received as compensation for loss of any office or employment.

(d) The rental value of any place of residence provided rent- free by the employer or where a place of residence is provided by an employer at a rent less than the rental value, the excess of the rental value over such rent.

In *The Executors of the Estate of N. E. Weerasooriya (Deceased) v. Commissioner-General of Inland Revenue it* was contended that an employer-employee relationship was necessary for Director's fees to be taxed as profits from any employment and that a director of a company was not an employee of the company and consequently the fees paid to a company director are not profits from employment as defined in section 6 (2) (a) (i) of the Income Tax Ordinance, [Section 4 (a) (b) (e) and d)] of Inland Revenue Act No 28 of 1979. It was held by the Supreme Court (per Wijesundere, J.) with Vithalingam, J. and Colin Thorne, J. agreeing, that director's fees came within the meaning of "profits from employment" as provided in the taxing statues referred to above. (In- come Tax Appeal S.C.-2 of 1975 decided on 23.06.1977 unreported).



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