The Curious Case of the Non-Executive Director: Employee or Businessman?

by Datuk D P Naban and Chris Toh Pei Roo

A recent report[1] on remuneration shows that non-executive directors (NEDs) of the 300 largest companies on Bursa Malaysia by market capitalisation received an average of RM162,000 per person annually; an increase of 33% over the RM122,000 in 2013.

This rise in remuneration reflects the increasingly prominent role that NEDs play in modern corporate governance, and which renders the tax treatment of their remuneration an increasingly important issue. In particular, this article discusses the important question of whether remuneration received by NEDs should be treated as business or employment income. The answer would affect what obligations NEDs and the companies they serve would have under tax laws, and how these should be discharged.

This article takes the view that although NEDs are not generally regarded as employees under employment and/or industrial relations law, the wider definition of "employees" under the Income Tax Act 1967[2] means that they should be treated as such for tax purposes, with the remuneration earned or paid to them as NEDs being recognised as employment income.

Definition of 'employee' differs under different legislation

The definition of an "employee" differs depending on the type of legislation in question and the particular objectives they are intended to promote. Social legislation, such as the Industrial Relations Act 1967[3] and the Employment Act 1955[4] for instance, are meant to afford protection to employees and workmen of lower income groups, while tax law is concerned chiefly with the collection of revenue.

Consider the following definitions in the Industrial Relations Act, the Employment Act and the Income Tax Act.

Industrial Relations Act[5]	**Employment Act[6]**
Employer Means any person or body of persons, whether corporate or unincorporate, who employs a workman under *a contract of employment*, and includes the Government and any statutory authority, unless otherwise expressly stated in this Act.	Employer Means any person who has entered into a *contract of service* to employ any other person as an employee and includes the agent, manager or factor of such first mentioned person, and the word "employ", with its grammatical variations and cognate expressions, shall be construed accordingly

Income Tax Act[7]

Employment
Means —

(a) employment in which the *relationship of master and servant* subsists;

(b) any appointment or office, whether public or not and *whether or not that relationship subsists*, for which remuneration is payable;

The above clearly illustrates a crucial distinction between the Income Tax Act as compared with the Industrial Relations Act and the Employment Act; the existence of a "contract of employment" or "contract of service" is essential in the Industrial Relations Act and the Employment Act, while the Income Tax Act only requires an "appointment" or "office" for which remuneration is payable. The reference to a "contract of service" stems from the common law, which draws a distinction between "contracts of service" and "contracts for service", whereby

1 KPMG Report on Non-Executive Directors' Remuneration 2017 <https://home.kpmg.com/content/dam/kpmg/my/pdf/KPMG_NEDReport2017_FINAL.pdf>
2 [*Act 53*]
3 [*Act 177*]
4 [*Act 265*]
5 Act 265, s 2
6 Act 177, s 2
7 Act 53, s 2

a person under the former would be regarded as an employee, while a person under the latter would not.

One of the most important distinctions between a "contract of service" and "contract for service" is whether or not a master-servant relationship exists between the parties. In other words, the existence or absence of a master-servant relationship is crucial in determining an individual's employment status under the Industrial Relations Act and the Employment Act. By contrast, the Income Tax Act expressly stipulates that the existence of a master-servant relationship is irrelevant for there to be "employment" so long as there is an "appointment" or "office" "for which remuneration is payable".

NEDs have different status under the Industrial Relations Act, Employment Act and Income Tax Act

As the legislation above adopt different definitions, it follows then that the employment status of NEDs differs under such differing legislation. This is nothing ground-breaking. Similarly, in the UK, the government advises that HM Revenue and Customs (HMRC) may regard a person's employment status for tax purposes as distinct from that under employment law.[8]

NEDs as non-employees under Industrial Relations Act and Employment Act

NEDs would not usually be regarded as "employees'" under the Industrial Relations Act and the Employment Act. NEDs are not generally regarded as "servants" of the organisations they serve, nor such organisations thought of as their "masters". It would not be appropriate to regard them as individuals under a "contract of employment" or "contract of service".

In any case:

(a) Since the landmark decision of the Supreme Court in *Inchape Malaysia*,[9] directors including NEDs cannot be regarded as "workmen" under the Industrial Relations Act as they perform distinct functions as the directing minds of the company;

(b) Employees are defined in the First Schedule of the Employment Act to mean persons whose wages do not exceed RM2,000 monthly. As is apparent from KPMG's report, NEDs generally receive remuneration significantly in excess of RM2,000 monthly.

NEDs as employees under Income Tax Act

By contrast, NEDs being holders of "appointments" and/or "office", and to whom remuneration is payable, should arguably be treated as "employees" under the Income Tax Act.

The wording of the definitions in the Income Tax Act is clearly meant to render irrelevant the consideration of whether or not a master/servant relationship exists in determining a person's employment status for tax purposes. In particular, the definition of employment clearly means that so long as there is an "appointment or office" "for which remuneration is payable", it does not matter "whether or not that relationship subsists".[10]

It is trite law that taxing statutes have to be read strictly. In the words of Rowlatt J in *Cape Brandy Syndicate v Inland Revenue Commissioners*:[11]

8 <https://www.gov.uk/employment-status/selfemployed-contractor>
9 *Inchape Malaysia Holdings Bhd v R B Gray & Anors* [1985] 2 MLJ 297
10 Act 53, s 2
11 [1921] 1 KB 64

> "… in taxation you have to look simply at what is clearly said. There is no room for any intendment; there is no equity about a tax: there is no presumption as to a tax; you read nothing in; you imply nothing".

Further, in the words of the Supreme Court in *Foo Loke Ying v Television Broadcasts Limited:*[12]

> *"*On the presumption that *Parliament does nothing in vain, the court must endeavour to give significance to every word of an enactment*, and it is presumed that if a word or phrase appears in a statute, it was put there for a purpose and must not be disregarded." [*Emphasis added*]

The proposition that NEDs should be treated as employees under the Income Tax Act draws some support from two particular cases.[13]

(i) S Sdn Bhd v Director General of Inland Revenue (1995) 2 MSTC 3440

Dr Y, who was the sole shareholder and governing director of the taxpayer company which ran a medical clinic, was paid certain sums monthly as remuneration for his services. Additionally, he was entitled to a share of the profit of the business and also had the air fares forf him and his family from Malaysia to the UK paid for biannually.

The Inland Revenue Board (IRB) sought to disallow the taxpayer's deduction of the payment of the share of profits paid to Dr Y on the basis that it was a bonus, and the amount paid for the air fares. The taxpayer company argued that Dr Y was a consultant and not an employee, and that the payments were contractual in nature and hence, deductible. It was further argued that Dr Y could not be an employee as it was illegal for him to accept employment in Malaysia as a non-citizen.

The High Court held that Dr Y was an employee of the taxpayer company. Referring to the definitions in the Income Tax Act, the High Court considered it clear that the master-servant relationship did not subsist. However, it was clear that "the appointment of consultant is an appointment for which remuneration is payable".

Unfortunately, the High Court then went on to conclude that "the employment agreement in this case is a contract of service and not a contract for services".

With respect, it is submitted that it was not necessary for the court to go back to this common law distinction. All that is required for Dr Y to be regarded as an employee for tax purposes is that the definition of employment within the Income Tax Act has been fulfilled.

(ii) DM v Ketua Pengarah Hasil Dalam Negeri (2001) MSTC 3215

The taxpayer and her husband were directors of a company that owned a residential house in which they resided. It was found that the taxpayer was not paid wages, salary, remuneration, leave pay, fee, commission, bonus, gratuity or allowance within the meaning of s 13(1)(a) of the Income Tax Act. However, the house, which had a market value of RM730,000 at that time, was subsequently transferred to the taxpayer

12 [1985] 1 CLJ 97
13 See, however, the SCIT's decision in *AMC Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2004) MSTC 3595

for the consideration of RM1. The IRB sought to tax the taxpayer on the amount of RM729,999 as a perquisite received by the taxpayer. The taxpayer argued that she was not an employee and had only been appointed director to fulfil the requirements of the Companies Act 1965.

The Special Commissioners of Income Tax (SCIT) accepted the taxpayer's argument and agreed that she was not an employee. In so holding, the SCIT appeared to have relied on the fact that it was in fact proved or admitted between the parties that no remuneration was received by the taxpayer.

In our view, however, the decision in *DM* was a missed opportunity for more guidance to be given on whether perquisites and other non-cash benefits could amount to "remuneration" that could render their recipients as employees within the meaning of the Income Tax Act.

Conclusion

If NEDs are indeed to be treated as employees under the Income Tax Act, several practical implications would arise, including:

(a) NEDs should recognise the fees they receive as employment income rather than business income for tax purposes. As a corollary to that, this would mean that the taxable income of NEDs would also include perquisites and other benefits they receive from the company;[14]

(b) On the part of the company, there would also be obligations to fulfil under the Income Tax Act such as the need to make and pay deductions to the IRB,[15] and to file EA forms.[16]

We hasten to add that our observations above are not meant to state that NEDs should be treated as employees outside of the limited confines of the Income Tax Act. The employment status of NEDs for employment and industrial relations purpose should be determined by exclusive reference to the Industrial Relations Act and the Employment Act and their corresponding case laws, just as the Income Tax Act provides its own exhaustive definitions for the purposes of tax laws. As highlighted above, this is nothing radical and the same is also true for jurisdictions such as the UK. In practical terms, this means that NEDs would not necessarily have employment rights such as that accorded to workmen and employees under employment and/or industrial relations law. Happily, in the context of the legal sector, this would also mean that lawyers who occupy the position of NEDs alongside their legal practice need not start worrying about losing their practising certificates.[17] **LH-AG**

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14 Act 53, s 13(1)
15 *Ibid*, ss 107 and 154; Income Tax (Deduction from Remuneration) Rules 1994, r 3
16 *Ibid*, s 83(1A)
17 Legal Profession Act 1976 [*Act 166*], s 30(1)(c) and 30(3)