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Beyond Nomenclature: Substance Over Form in Employer–Employee Relationships under GST



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1. Introduction

The decision of the Karnataka High Court in *Karnataka Vikas Grameena Bank v. Deputy Commissioner of Commercial Taxes (Enforcement-2)* [(2026) 41 Centax 372 (Kar.)] assumes considerable importance in the evolving landscape of GST, where the scope of "supply" is often tested against modern and hybrid working arrangements. With revenue authorities increasingly seeking to characterise diverse engagements as taxable transactions, disputes around the true nature of relationships—particularly those hovering between employment and independent service—have become more frequent. Against this backdrop, the present ruling offers a timely and principled intervention, anchoring the analysis firmly in settled doctrines of law.

At the heart of the controversy lies the statutory scheme of Section 7 of the CGST Act. In terms of Section 7(2)(a) read with Schedule III, services by an employee to the employer in the course of or in relation to employment are expressly kept outside the ambit of "supply," and therefore, beyond the levy of GST. This exclusion is a clear legislative recognition that employment is not a commercial transaction amenable to indirect taxation. The judgment builds upon this foundation and reiterates that once a relationship answers to the characteristics of employment, the inquiry must end there. Labels such as "agent" or the mode of remuneration being termed as "commission" cannot alter the intrinsic nature of the relationship. In reaffirming this position, the Court once again underscores the enduring principle that substance must prevail over form, bringing clarity and discipline to the application of GST law in such contexts.

2. Factual Background

The petitioner, a Regional Rural Bank established under the provisions of the Regional Rural Banks Act, 1976, was subjected to inspection by the State Tax Department under Section [67](#) of the CGST Act. The inspection led to allegations that the Bank had failed to discharge GST under the reverse charge mechanism on commission paid to pigmy agents engaged in its urban branches.

The Bank consistently maintained that pigmy agents were, in substance, its employees and that the payments made to them, though termed as commission, were in the nature of salary. It was further argued that such agents did not qualify as business facilitators so as to attract reverse charge liability. The department, however, rejected this position and proceeded to issue the impugned show cause notices, forming the basis of the present challenge.

3. Issue Before the High Court

The Hon'ble High Court framed the central issue in clear terms:

"Whether the petitioner is liable to discharge Goods and Services Tax, on the services rendered and commission paid to the pigmy agents?"

4. Submissions of the Petitioner

The petitioner contended that pigmy agents are employees of the Bank and, therefore, their services fall outside the purview of GST. Reliance was placed upon Section 7(2)(a) read with Sl. No. 1 of Schedule III of the CGST Act, which excludes services rendered by an employee to the employer in the course of employment from the scope of supply.

It was further submitted that pigmy agents have been recognised as "workmen" under the Industrial Disputes Act, 1947, as held by the Supreme Court in *Indian Bank's Association's* case [(2001) 3 SCC 36]. The deduction of TDS on payments made to such agents was cited as an additional indicator that the remuneration partakes the character of salary.

The petitioner also argued that pigmy agents do not fall within the ambit of "business facilitators" under the relevant reverse charge notification dated 28-06-2017, nor are they intermediaries appointed under the regulatory framework of the Reserve Bank of India. Accordingly, the show cause notices were challenged as being without jurisdiction.

5. Submissions of the Revenue

The Revenue defended the issuance of the show cause notices, asserting that the commission paid to pigmy agents attracts GST under the reverse charge mechanism in terms of Section 9(3) of the CGST Act. It was contended that the payments were in the nature of commission and not salary, thereby excluding the application of Schedule III.

The department further argued that the Bank had failed to establish the existence of an employer-employee relationship. It was also submitted that pigmy agents function akin to business facilitators or correspondents engaged in financial services, and the RBI circulars relied upon by the petitioner do not preclude such classification.

6. Discussion & Findings of the High Court

6.1 Determination of GST Applicability on Pigmy Agents' Services

The Court undertook a detailed examination of Section 7 of the CGST Act, particularly in light of Section 7(2)(a) and Schedule III. It held that the statutory scheme unequivocally excludes services rendered by an employee to an employer in the course of employment from the ambit of "supply." This exclusion, being explicit and unambiguous, leaves little room for interpretative dilution.

Recognising that the CGST Act does not define "employer" or "employee," the Court turned to established judicial precedents to delineate their contours. On a careful appreciation of the nature of duties performed by pigmy agents, the Court concluded that the relationship bore all the essential attributes of employment.

6.2 Contractual Terms Revealing the True Nature of Engagement

A close reading of the agreements between the Bank and the pigmy agents revealed critical indicators of an employment relationship. The Bank exercised pervasive control over the functioning of the agents, who were required to maintain security deposits, adhere to prescribed procedures, and operate within a structured framework.

The agents were assured minimum remuneration and were entitled to benefits such as gratuity. Their disengagement was subject to notice requirements, further reinforcing the structured and regulated nature of their engagement. These features, the Court observed, are emblematic of employment rather than independent contractual arrangements.

6.3 Judicial Tests Governing Employer-Employee Relationship

The Court drew extensively from established Supreme Court jurisprudence to analyse the nature of the relationship.

In *Indian Banks Association*, the Supreme Court held:

"25. Further, as seen from Section 2(rr) of the Industrial Disputes Act, the commission received by Deposit Collectors is nothing else but wage, which is dependent on the productivity. This commission is paid for promoting the business of the various banks.

26. ...the Deposit Collectors... are accountable to the Bank and under the control of the Bank."

This authority firmly establishes that commission-based remuneration does not negate the existence of employment where control and supervision are present.

Similarly, in *Dharangadhara Chemical Works Limited v. State of Saurashtra* [1956 SCC OnLine SC11], it was held:

"14. The principle... is the existence of the right in the master to supervise and control the work... including the manner in which he shall do his work."

The Court also relied on *Hussainbhai v. Alath Factory Thezhilali Union* [(1978) 4 SCC 257], which emphasised the concept of economic dependence as a decisive indicator of employment.

6.4 The Evolving Test: Contract of Service vs Contract for Service

Moving beyond the traditional control test, the Court acknowledged the evolution of jurisprudence in distinguishing a "contract of service" from a "contract for service." The analysis now encompasses multiple factors, including integration with the employer's business, economic dependence, ownership of tools, and the overall commercial reality of the arrangement.

The Court aptly noted that no single test is determinative; rather, it is the cumulative effect of all relevant factors that must guide the conclusion. This balanced and holistic approach ensures that complex modern work arrangements are assessed with doctrinal fidelity.

6.5 Rejection of the 'Intermediary' Classification

The Court categorically rejected the Revenue's attempt to classify pigmy agents as business facilitators or intermediaries. It held that the role of such agents is confined to deposit collection under the Bank's schemes and does not align with the functions envisaged under the RBI's business facilitator model.

The classification sought by the department was found to be an artificial construct, lacking factual and legal foundation, and therefore incapable of sustaining the levy.

7. Final Findings of the Court

The Court distilled the governing principles with clarity: the degree of control, supervision, and economic dependence are decisive in determining the existence of an employment relationship. Where these elements converge, the relationship assumes the character of a master-servant nexus.

Applying these principles, the Court held that pigmy agents are employees of the Bank. Consequently, the services rendered by them fall squarely within the exclusion under Sl. No. 1 of Schedule III to the CGST Act and are not exigible to GST.

The show cause notices, being founded on an erroneous characterisation of the relationship, were held to be legally unsustainable. The Court observed that when the very foundation of the demand is flawed, the entire superstructure built upon it must necessarily collapse.

8. Interpretation in the Absence of Statutory Definitions

An important jurisprudential aspect reaffirmed in the present case is that where statutory expressions are not defined in the enactment, their meaning must be gathered from settled judicial dicta and established legal principles. Terms such as "employer" and "employee," though undefined under the CGST Act, are not devoid of content; their contours have been consistently shaped through a rich body of case law. In such situations, it is impermissible for authorities to adopt artificial or expansive meanings divorced from judicial precedent. Instead, interpretative discipline demands adherence to the settled understanding of such expressions as evolved by constitutional courts, ensuring consistency, certainty, and coherence in tax administration.

This principle has wide application across GST and is not confined to employer-employee relationships alone. For instance, the concept of "intermediary" under the IGST framework, though defined, has repeatedly been interpreted by

courts by drawing upon settled jurisprudence to prevent over-expansion by tax authorities. Similarly, expressions such as "composite supply" and "mixed supply" under Section 2 of the CGST Act, or "in the course or furtherance of business" under Section 7, often require contextual and judicial interpretation to determine their true scope in complex transactions. In sectors such as e-commerce and digital services, the characterization of platform operators—as principals or intermediaries—frequently turns on judicially evolved tests rather than mere contractual wording.

A particularly relevant illustration arises in the context of input tax credit restrictions under Section 17(5) of the CGST Act, especially concerning the expression "plant and machinery" in building construction disputes. While the statute provides an explanation, significant controversy persists regarding whether certain structures—such as warehouses, telecom towers, pipelines, or embedded civil foundations—qualify as "plant and machinery" or are hit by the exclusion relating to immovable property. Courts have consistently held that such determination cannot rest on a narrow or literal reading alone, but must consider functional utility, degree of permanency, and integration with business operations, drawing upon well-settled jurisprudence from earlier tax regimes. The meaning of "plant" in particular has historically received a wide and functional interpretation, encompassing apparatus used for carrying on business, and this interpretative legacy continues to inform GST disputes as well.

Likewise, in the real estate sector, questions surrounding "works contract" vis-à-vis sale of immovable property, or in the secondment of employees across group entities, the determination of taxability hinges on judicially settled principles rather than statutory definitions alone. Even in financial services, classification disputes—such as whether an activity constitutes "facilitation" or independent supply—are resolved by applying established legal tests. The present ruling thus reinforces a broader interpretative discipline: that GST, being a law of wide amplitude, must be applied through the lens of settled legal meaning, and not through isolated or revenue-driven interpretations of undefined expressions.

9. Centrality of Employment Contracts in Determining Taxability

The ruling once again underscores that in cases involving characterization of relationships, the employment contract and its underlying substance assume critical importance. The language of the agreement, the rights and obligations it creates, and the manner in which it is implemented in practice collectively determine the true nature of the engagement. Mere labeling of remuneration as "commission" or describing a person as an "agent" cannot override the real nature of the relationship if the contractual terms reveal elements of control, supervision, and integration. Therefore, careful drafting and structuring of employment contracts is not merely a matter of form, but a decisive factor in determining GST implications.

10. Conclusion

This ruling is a significant reaffirmation of first principles in GST law. It underscores that taxability cannot be determined by labels or contractual semantics, but must be grounded in the real nature of the relationship. In an era where businesses increasingly adopt flexible and hybrid engagement models, the judgment provides a principled framework to assess such arrangements without losing sight of statutory intent.

Equally, the decision serves as a caution to tax authorities against overzealous classification exercises that disregard settled jurisprudence. The exclusion of employer-employee services from GST is not a narrow exception but a deliberate legislative choice, rooted in the recognition that such relationships fall outside the domain of commercial supply.

As disputes in this area continue to evolve, this judgment will likely serve as a guiding precedent, reinforcing the doctrine that in taxation, as in all branches of law, *substance must prevail over form*.