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Bonus paid to employee-shareholder can be disallowed only in case of tax avoidance, evasion

The Mumbai Bench of the Income-tax Appellate Tribunal (ITAT) rendered its decision that bonus paid to employee-shareholder cannot be disallowed, unless a clear finding of tax avoidance/evasion is given by the tax authorities.

Background:

- The taxpayer¹ is a depository participant engaged in the business of share / stock broking.
- During Financial Year (FY) 2011-12, corresponding to Assessment Year (AY) 2012-13, the taxpayer paid INR 500,000 to its two directors (i.e. INR 250,000 million each) as bonus and incentive, in addition to payment made to them as director's remuneration.
- During the audit proceedings, the Assessing Officer (AO) disallowed the bonus payment aggregating to INR 500,000 under section 36(1)(ii) of the Income-tax Act, 1961 (ITA) on the following grounds:
 - The taxpayer had more than INR 10 million of profits which could have been distributed amongst the shareholders in the form of dividend.
 - The two directors held shares of the taxpayer and the said amount of INR 250,000 each, if not paid to them as bonus, was payable as dividend to the two shareholders.
 - The AO had relied on an earlier case² of the Mumbai Special Bench of the Income-tax Appellate Tribunal (ITAT).

As per section 36(1)(ii) of the ITA, deduction in respect of any sum paid to an employee as bonus or commission for services rendered is allowed, where such sum would not have been payable to him as profits or dividend if it had not been paid as bonus or commission.

- On appeal by the taxpayer, the Commissioner of Income-tax (Appeals) [(CIT(A)] upheld the AO's order.
- Aggrieved by the CIT(A)'s order, the taxpayer filed an appeal before the Mumbai Bench of the ITAT.

Decision of the ITAT:

- The ITAT noted the following:

¹ Mehta Equities Ltd. v. DCIT (ITA No. 5850/Mum/2019) (Mumbai ITAT)

² Dalai & Broacha Stock Broking Pvt. Ltd. v. ACIT [2011] 131 ITD 36 (Mumbai ITAT)

- In the case³ of the Bombay HC (relied upon by the tax authorities during the proceedings before the ITAT), the Bombay HC had actually allowed payment of bonus to the employee shareholders under the provisions of the old ITA [which was pari materia to section 36(1)(ii) of the ITA]. The case³ of the Special Bench of the Mumbai ITAT quoted by the AO was also a paragraph / passage of the said case. The said case was based upon the categorical finding that it was a tax evasion scheme adopted by the taxpayer and in this fact the Special Bench had quantified the amount of tax avoidance involved.
- In view of the above, the ITAT held that:
 - If the AO wanted to invoke provisions of section 36(1)(ii) of the ITA based on the case² of the Special Bench of the Mumbai ITAT, the AO would have to give clear finding as to what was tax avoidance or tax evasion involved in the case under consideration. For this purpose, the AO would need to examine the amount of dividend which the taxpayer would have declared under the provisions of relevant payment of dividend as per the Companies Act and also compute tax sought to be avoided by the taxpayer.
 - The SC in an earlier case⁴ had expounded that if the tax effect was revenue neutral, the proposition need not be disturbed.
 - The AO was required to examine the taxpayer's submission that both the shareholder directors had filed their individual tax return and had been taxed at the highest bracket, in the context of this SC decision. The tax impact and the emerging tax neutrality, if any, was to be evaluated on the touchstone of this decision also. The claim in this regard was duly submitted by the taxpayer and noted by the CIT(A) in this order.

Accordingly, in view of the above, the ITAT set aside the issue of allowability of bonus payment (to the shareholder directors) in accordance with the ITAT's direction and cases quoted above.

Comment:

This ruling lays down the principle that payment of bonus or commission made to shareholder employees can be disallowed only if there is a case of tax avoidance or evasion.

³ Loyal Motor Service Co. Ltd. Vs Commissioner of Income Tax (14 ITR 647)

⁴ CIT v. Excel Industries Ltd. [2018] 38 taxmann.com 100 (SC)



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