

## LT in Focus

# Payment of annual bonuses: trends and practice

With the end of financial year approaching, annual bonuses are getting high on the agenda for most companies.

Although the payment of bonuses is mainly governed by internal corporate policies, we evidence an increasing attention of the tax authorities to the size of annual bonuses (especially paid to top managers) and their deductibility.

For example, a case where the position of the tax authorities that deducting annual employee bonuses was unjustified as lacking economic substance was upheld by Resolution of the Moscow District Commercial Court of 19 July 2016 issued on Case [A40-118598/2015](#).

The trend towards a stronger control can be also seen in draft Federal Law No. [51799-7](#) which is aimed at limiting the size of annual bonuses paid to the top managers of state-owned institutions and companies, and in the new wording of Article 136 of the Labour Code, which refines the requirements to bonus payment timeline (for details please refer to LT in Focus of [11 August](#) and [11 October](#) 2016).

This Issue offers a snapshot of the main trends in annual bonus payment and our analysis of related challenges.

### [Regulatory framework](#)

#### [Deductibility of annual bonuses](#)

#### [Position taken by tax authorities and courts](#)

#### [Recommendations](#)

### Regulatory framework

The current labour legislation (Article 129 of the Labour Code) treats all incentives, including annual bonuses, as an integral payroll component (part of salary). At the same time, incentive plans (the types of rewards, calculation and the decision-making procedures) are developed by each company internally and are included into employment contracts or collective agreements, as well as formalised in the corporate policies (e.g., in Employee Incentive Policy).

The Corporate Governance Code<sup>1</sup> (hereinafter, the Code) recommended by the Central Bank of Russia for listed companies sets forth the basic principles for incentive systems:

- ✓ Bonuses for top managers should be managed to ensure a reasonable and justified balance between the fixed and the variable components;
- ✓ The variable component should be based on the company's performance and on the individual contribution to the company's results;
- ✓ The individual KPIs underlying the short-term motivation system should be relevant and aligned with the long-term strategy of the company;
- ✓ The long-term motivation system for top-managers should include company share option plans.

The Code is not mandatory.

Summing up, the Russian legislation currently sets no annual bonus caps.

<sup>1</sup> Letter of the Central Bank of Russia "On Corporate Governance Code" No. [06-52/2463](#) of 10.04.2014"

Contrariwise, in its Guidance "On audit of remuneration systems in credit institutions and serving injunctions to cure breaches therein"<sup>2</sup> No. [154-I](#) of June 17, 2014 (hereinafter, the Guidance), which is mandatory, the Central Bank of Russia notes that the variable component paid to credit institution's executive / risk-taking employees must be **at least 40%** of their total compensation, provided the credit institution's performance targets are met. Otherwise, the variable component can be lower than 40% or not paid at all.

The similar approach to incentivising the risk-takers is recommended by the Bank of Russia in its guidance<sup>3</sup> on payroll management and disclosure for certain non-credit financial institutions, aiming to prevent excessive exposure and maintain financial stability.

Although applying to a limited range of companies, these recommendations of the Central Bank of Russia illustrate its position that the annual bonuses of risk-takers should depend on their performance, i.e. on company's financial results.

A large part of the compensation's being variable and performance-based is meant to incentivise employees and drive their performance. Both the Code and the Guidance are based on the global best practices in remuneration, with the variable pay depending on the level of risk assumed and the individual contribution to the company's financial results: the higher the position, the bigger the variable component, which, in case of poor performance, might not be paid at all, or increase materially if the company's targets are exceeded.

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## *The Central Bank of Russia recommends setting the variable bonus component for credit institution executives at no less than 40% of the total remuneration.*

At the same time, we can see how the tax authorities are paying more and more attention to the justification of bonus deductions for profit tax purposes during tax audits.

The tightening of control over bonus payments is evidenced by Draft Law No. [51799-7](#)<sup>4</sup> pending in the Russian State Duma's Committee for Labour, Social

Policy and Veterans Affairs. The draft is aimed at limiting the annual bonuses for top managers of state-owned institutions and companies to triple their average monthly pay. In our opinion, it runs contrary to the underlying economic essence and purpose of incentive payments, as the annual bonus size must depend solely on the company's results and individual performance, therefore, may well exceed the triple monthly pay.

### **Deductibility of annual bonuses**

Given that various incentive payments set by the companies are treated by the Labour Code as part of employee's compensation, they can be deducted for tax purposes based on Item 2, Article 255 of the Russian Tax Code, subject to the following criteria:

1. The payment of bonuses must be envisaged in the employment contract and (or) collective agreement or other local corporate policies, and supported by an internal order.
2. The employer's bonus expenses must be justified.

Justified expenses refer to economically justified costs with a value expressed in monetary terms.

3. The bonuses must not be paid out of special-purpose funds or special-purpose receipts.

While meeting the first and the third criteria is not a problem, the interpretation and the implementation of the second requirement is an issue due to the ambiguity of the concept of "expense justification" and its treatment by the tax and judicial authorities.

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## *Annual bonuses must be economically justified, i.e. be consistent with company's performance and employee's individual contribution.*

### **Position taken by tax authorities and court practice**

The tax authorities have always placed a special emphasis on the justification of executive bonus deductions for profit tax purposes. They are increasingly challenging such deductions as being economically unjustified, if any of the following applies:

- ✓ The incurred expenses have not resulted in income

generation;

- ✓ The expenses are inconsistent with the income;
- ✓ The company reports a loss in its financial statement.

<sup>2</sup> The Central Bank of Russia Guidance on Payroll Policies and Elimination of Related Breaches by Credit Institutions No. [154-I](#) of 17.06.2014

<sup>3</sup> The Central Bank of Russia Information Letter No. IN-06-54/53 of 14 July 2016 (Bank of Russia Bulletin № [69](#))

<sup>4</sup> Draft Federal Law "On Amendments in Article 145 of the Russian Labour Code № [51799-7](#)

Formerly, the courts used to take the taxpayer's side citing the principle of economic liberty (Article 8, Part I of the Russian Constitution) and holding that the economic feasibility and relevance of expenses can only be defined by the company itself<sup>5</sup>, but in Resolution of 19 July 2016<sup>6</sup>, the Moscow District Commercial Court supported the tax authorities in the dispute over deductibility of annual employee bonuses for profit tax purposes.

The Court cited the following reasons why the expenses were not economically justified:

1. The person awarding the annual bonus was the bonus recipient's direct report;
2. The bonus paid was inconsistent with the

employee's performance;

3. The bonuses were paid out of the non-state pension fund's assets held in fiduciary management, with the investment performance results being negative for the beneficiaries.

As the tax authorities are clamping down on executive annual bonuses and taking into account the reasons cited by the Court in this case, we recommend that the companies always be prepared to justify the economic relevance and the business purpose of bonus payments.

Otherwise, the tax authorities can challenge the deductibility of such expenses for profit tax purposes.

## Recommendations

Summarising this issue: to minimise the potential tax claims and, if necessary, defend one's position in court, we recommend that the companies intending to pay employee bonuses for 2016 do the following (and adjust their local bonus policies and approaches accordingly):

1. The companies need to thoroughly monitor the changes in the tax and labour legislation as it's trending towards a tighter regulation.
2. The procedure for and the timeline of annual bonus payment need to be revised according to the amendments to Article 136 of the Labour Code.
3. The companies need to be prepared to justify the economic relevance of annual bonuses should any

questions from the tax authorities arise (e.g., link the company's performance and respective employee's contribution/individual performance, make sure that there's no relation between the decision-makers and the bonus recipients, etc.).

4. The companies need to make sure that all paperwork underlying the payment of bonuses is in place (e.g. the bonus payment criteria must be envisaged by the employment contracts, collective agreements or other local policies; bonus calculations must be documented, illustrating how the bonus is linked to the company's financial results and to the individual performance; internal orders on payment of bonuses must be issued).

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We hope that you will find this newsletter interesting and informative. Please feel welcome to contact us for more information on the topics covered.

Best regards,

**Deloitte CIS Partners**

<sup>5</sup> Resolution of Volga District Commercial Court of 17.02.2015 No. [Φ06-20220/2013](#)

<sup>6</sup> Resolution of Moscow District Commercial Court of 19.07.2016 No. [A40-118598/2015](#)

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### TaxSmart app



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