

29 June 2011

# EY Tax Alert

Special Bench of the Mumbai ITAT rules on commission paid in lieu of dividend



## Executive summary

This Tax Alert summarizes a recent ruling of the Special Bench (SB) of the Income Tax Appellate Tribunal (ITAT) of Mumbai [ITA No. 5792/Mum/2009]<sup>[1]</sup> in the case of Dalal Broacha Stock Broking Pvt. Ltd. (Taxpayer). The SB was constituted to examine whether the commission paid to employee directors, who were the only shareholders, was allowable as deduction under a specific provision (Section) of the Indian Tax Laws (ITL) which does not permit deduction for bonus or commission paid to an employee in lieu of profits or dividends. The SB, based on the facts of the case, held that amount paid to the directors was in lieu of dividend and, hence, the same was not allowable as deduction from business income.

## Background and facts

- ▶ The Section allows deduction for any sum paid to an employee as bonus or commission for services rendered where such sum would not have been payable to him as profits or dividend. The ITL also has a general provision in terms of which any revenue expenditure which is not covered by any specific provision and is incurred wholly and exclusively for business purposes is allowable as deduction. Furthermore, it also contains a provision for disallowance of excessive or unreasonable payments made to related parties, including directors.

<sup>[1]</sup><http://itatonline.org/>

- ▶ If bonus or commission is allowed as deduction, it is taxable in the hands of the employees. The maximum marginal tax rate for individuals for the tax year under consideration i.e., 2005-06 was 30%. On the other hand, if the bonus or commission is regarded as dividend, while there would be no taxation in the hands of the employee, the company suffers disallowance and is also liable for dividend distribution tax.
- ▶ The Taxpayer, a stock broking company in India, paid commission to three of its directors, who were the only shareholders of the company. The commission was paid in addition to regular salaries.
- ▶ The shareholding position and the amount of commission paid to the three directors in tax year 2005-06 was as follows:

Director	Shareholding	Amount of commission
A (Father)	50%	INR4m
B (Son1)	25%	INR4m
C (Son2)	25%	INR4m
<b>Total</b>	<b>100%</b>	<b>INR12m</b>

The total profits for the tax year 2005-06 were INR105m.

- ▶ In the past, the Taxpayer had paid similar commission in tax year 1999-00. No commission was paid during tax years 2000-01 to 2002-03.

The payment was again made from tax year 2003-04 onwards. The Tax Authority disallowed the commission for tax years 2003-04, 2004-05 and 2006-07 but it was allowed by the Division Bench (DB) of the Mumbai ITAT whose decision was accepted by the Tax Authority by not filing further appeal to the High Court.

- ▶ For the relevant tax year 2005-06, the Tax Authority persisted with the disallowance on the ground that in the facts of the case the commission paid was in lieu of dividend.
- ▶ On appeal by the Taxpayer, the first appellate authority upheld the disallowance.
- ▶ On further appeal by the Taxpayer, the DB of the Mumbai ITAT, to which the issue was referred for tax year 2005-06, referred the matter for consideration by an SB since the DB was not in agreement with the earlier decision.

## Issue before the SB

Whether in the facts and circumstances of the case, the payment of commission was disallowable, being in lieu of dividend.

## Taxpayer's contentions

- ▶ The commission was paid to the directors in terms of a Board resolution for extra efforts they had put in for improving profits of the company.

- ▶ The commission cannot be regarded as in lieu of dividend. The Taxpayer was not obliged to declare dividends on its profits. Hence, it could not be said that, if commission was not paid, the directors would have received it in the form of dividend.
- ▶ Furthermore, the commission was not paid in proportion to the shareholding of the three respective directors. Hence, it could not be regarded as dividend.
- ▶ Alternatively, since there was no dispute that the commission was paid wholly and exclusively for business purpose, even if any part thereof was disallowable under the Section, the same was fully allowable under the general provision.
- ▶ The Taxpayer also argued that since the commission payment in other years was allowed by the Mumbai ITAT, following the rule of consistency, the same should be allowed for tax year 2005-06 also.
- ▶ Reliance was placed on the Bombay High Court (HC) ruling in the case of Loyal Motor Services Co. Ltd. v CIT<sup>[2]</sup> (Loyal Motor ruling) where the HC held that commission can be disallowed only where the amount, if not paid as commission, is payable as dividend.

## Tax Authority's contentions

- ▶ The reasonableness of commission payment or rendering of extra services by directors are not relevant factors in view of specific provisions of the ITL. The disallowance under the Section is attracted if it is established that, if not paid as commission, the amount would be paid as dividend.
- ▶ Furthermore, except the directors, the Taxpayer did not pay any commission to any other employee. The commission was paid only to the directors who were also the only shareholders, which clearly showed that the payment of commission was in lieu of dividend.
- ▶ The decision of the shareholder directors to pay commission instead of declaring dividend was motivated by the intention to avoid tax, since dividend payment would have resulted in higher tax outflow for the Taxpayer as compared to tax payable by the directors on the commission.

## SB's ruling

The SB upheld the disallowance of commission under the Section by adopting the following reasoning:

- ▶ The object of the Section is to allow payment of bonus or commission to an employee even if the payment is made out of profits of the taxpayer. It

was inserted in the predecessor ITL as a sequel to a judicial ruling that, if quantification of an expenditure is based on determination of profits then such expenditure cannot be allowed as deduction since it represents application of profits. The deduction is, however, subject to the condition that the bonus or commission is not paid in lieu of dividend. It is not necessary that payment should be made commensurate with the rendering of services or there should be some extra services rendered.

- ▶ If a reasonable conclusion can be drawn in the light of the entirety of the facts and circumstances that the dividend was payable and the taxpayer, instead of paying dividend paid commission to its employee shareholders, such payment of commission would be in lieu of dividend and is disallowable under the Section.
- ▶ If the employees have rendered any extra services for payment of commission, it would be one of the relevant factors to consider, whether the payment is made in lieu of dividend or not. In the present case, no evidence is available on record to support the plea that the employee directors had rendered any extra services for payment of commission in addition to services rendered as an employee for which salary has been paid.
- ▶ Reference to the Taxpayer's financial results for past years makes it clear that the Taxpayer paid commission only when it made exceptional profits. Moreover, the commission was paid only to the directors who were the only shareholders. No such commission was paid to other employees.

<sup>[2]</sup> [14 ITR 647]

- ▶ The Taxpayer, being a stock broking company, gets brokerage on sale/purchase of shares by investors/traders. The income of the Taxpayer is assured irrespective of whether the investor/trader loses or gains in the transaction. The quantum of brokerage, however, depends upon the market conditions. The steady rise in the Taxpayer's performance over the years was due to improved market conditions and not because of any extra service rendered by the directors, as no evidence has been produced in support of rendering of extra services. Hence, considering the totality of the facts and circumstances, it can be concluded that the commission in the present case was paid in lieu of dividend.
- ▶ The Loyal Motor ruling relied on by the Taxpayer is distinguishable. In that case, commission was also paid to other employees besides the shareholder employees, whereas in the present case, commission was paid only to employees who were also shareholders.
- ▶ The alternative contention of the Taxpayer that commission should be allowed as deduction under general provisions also cannot be accepted in light of Bombay HC ruling in the case of Subodhchandra Popatlal v CIT <sup>[3]</sup>. In this ruling, the Bombay HC held that deductibility of expenditure in the nature of bonus or commission to employees for services rendered should be determined by the tests laid down under the specific provisions of the Section and not the general provision.
- ▶ The DB rulings for earlier years are not binding on the SB. The rule of consistency cannot be applied when a DB, of a later year, does not find the earlier decisions of the DB to be correct and, hence, refers the matter to an SB.

## Comments

It is a well-established convention to consider the SB's decision as binding on the DBs of the ITAT.

The SB ruling confirms that whether a bonus or commission is paid in lieu of dividend is a fact-based issue to be decided on a consideration of totality of facts and circumstances of a particular case. The SB ruling emphasizes the need to support the payment of bonus or commission to employee shareholders with robust documentation which demonstrates that the payment is for services rendered and not in lieu of dividend. Also, a circumstance where commission is paid to other employees (and not merely shareholders) would additionally support that it is not in lieu of dividend.

<sup>[3]</sup> [24 ITR 566]

# Our offices

## Ahmedabad

2nd floor, Shivalik Ishaan  
Near CN Vidhyalaya Ambawadi  
Ahmedabad - 380 015  
Tel: + 91 79 6608 3800  
Fax: + 91 79 6608 3900

## Bengaluru

"UB City", Canberra Block  
12th & 13th floor  
No.24 Vittal Mallya Road  
Bengaluru - 560 001  
Tel: + 91 80 4027 5000  
+ 91 80 6727 5000  
Fax: + 91 80 2210 6000 (12th floor)  
+ 91 80 2224 0695 (13th floor)

## Chennai

TPL House, 2nd floor  
No. 3 Cenotaph Road Teynampet  
Chennai - 600 018  
Tel: + 91 44 6632 8400  
Fax: + 91 44 2431 1450

## Hyderabad

205, 2nd floor  
Ashoka Bhoopal Chambers  
Sardar Patel Road  
Secunderabad - 500 003  
Tel: + 91 40 6627 4000  
Fax: + 91 40 2789 8851

Oval Office, 18, iLabs Centre  
HITECH City, Madhapur  
Hyderabad - 500081  
Tel: + 91 40 6736 2000  
Fax: + 91 40 6736 2200

## Kochi

9th Floor, Abad Nucleus  
NH-49, Maradu PO  
Kochi -682304  
Tel: +91 484 3044000  
Fax: +91 484 2705393

## Kolkata

22 Camac Street  
Block 'C', 3rd floor  
Kolkata - 700 016  
Tel: + 91 33 6615 3400  
Fax: + 91 33 2281 7750

## Mumbai

14<sup>th</sup> floor, The Ruby,  
Dadar, Mumbai - 400 028.  
Tel: + 91 22 6192 0000  
Fax: + 91 22 6192 1000

6<sup>th</sup> Floor, Express Towers,  
Nariman Point,  
Mumbai - 400 021  
Tel: + 91 22 6657 9200  
Fax: + 91 22 2287 6401

Block B-2, 5th Floor  
Nirlon Knowledge Park  
Off. Western Express Highway  
Goregaon (E), Mumbai - 400 063.  
Tel: + 91 22 6749 8000  
Fax: + 91 22 6749 8200

## NCR

Golf View Corporate Tower B  
Near DLF Golf Course Sector 42  
Gurgaon - 122002  
Tel: + 91 124 464 4000  
Fax: + 91 124 464 4050

6th floor, HT House  
18-20 Kasturba Gandhi Marg  
New Delhi - 110 001  
Tel: + 91 11 4363 3000  
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2,  
Sector 126, NOIDA 201 304  
Gautam Budh Nagar, U.P. India  
Tel: + 91 120 671 7000  
Fax: + 91 120 671 7171

## Pune

C-401, 4th floor Panchshil Tech Park  
Yerwada (Near Don Bosco School)  
Pune - 411 006  
Tel: + 91 20 6603 6000  
Fax: + 91 20 6601 5900

Ernst & Young Pvt. Ltd.

Assurance | Tax | Transactions | Advisory

### About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit

[www.ey.com/india](http://www.ey.com/india)

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Ernst & Young Private Limited is one of the Indian client serving member firms of Ernst & Young Global Limited.

Ernst & Young Pvt. Ltd is a company registered under the Companies Act, 1956 having its registered office at 22, Camac Street, Block C, 3<sup>rd</sup> Floor, Kolkata- 700016

© 2011 Ernst & Young Pvt. Ltd.  
All Rights Reserved.

Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young Pvt. Ltd. accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.