Deloitte.

Tax Alert | Delivering Clarity

30 December 2020

Cashless exercise of stock options is subject to capital gains tax

The Karnataka High Court gave its decision that in the absence of employer-employee relationship, gain on cashless exercise of stock options is subject to capital gains tax.

Background:

- The taxpayer[1] is a software engineer who was employed with an Indian company (I Co) between the period 1995-1998. He was deputed to a US company (US Co) in 1995 by the I Co as an independent consultant. The taxpayer served the US Co from 1995-1998 as an independent consultant and later as an employee of the US Co from 2001-2004. The taxpayer thereafter returned to India and took up employment with an Indian group company of the US Co.
- While on deputation to the US Co, the taxpayer was granted stock options by the US Co whereunder, the taxpayer was given right to purchase 30,000 shares of the US Co at an agreed upon exercise price.

  The taxpayer also had an option of cashless exercise of stock options (i.e. the underlying shares are not allotted to the taxpayer and he is only entitled to receive the sale proceeds less the exercise price).
- In the Financial Year (FY) 2005-06, corresponding to Assessment Year (AY) 2006-07, the taxpayer exercised his right under stock option plan by way of cashless exercise and offered the gain (i.e. net consideration) as a long-term capital gain (as the stock options were held nearly for 10 years). The taxpayer also claimed deduction under section 54F of the Income-tax Act, 1961 (ITA).

  Section 54F of the ITA provides certain relaxation (subject to satisfaction of conditions) from long-term capital gains, in case of investment by the taxpayer in residential house.
- During the audit proceedings, the Assessing Officer (AO) artificially split the transaction into two and taxed:
  - The difference between the market value of shares on the exercise date and the exercise price as 'income from salary'; and
  - The difference between the sale price of shares and market value of shares (on the exercise date) as 'income from short-term capital gains'.

  Further, the claim for deduction under section 54F of the ITA was also disallowed.
- In appeal proceedings, the matter reached the Karnataka High Court (HC).

[1] Chittaranjan A. Dasannacharya v. CIT [2020] 122 taxmann.com 162 (Karnataka HC)

Decision of the HC:

Employer-employee relationship

- The HC took note of the relevant clauses of the stock plan, communication from the US Co to the taxpayer and observed that the taxpayer was an independent consultant to the US Co (and not an employee of the US Co) at the relevant time.

  Further, the HC noted that the Supreme Court (SC) in an earlier case[2] had held that unless the relationship of employer and employee existed, the income could not be treated as salary.

  Accordingly, the HC held that there was no employer-employee relationship between the US Co and the taxpayer, and the income could not be treated as salary.

Right to subscribe shares a capital asset

- The HC further noted the following:
  - The SC in another case[3] had held that right to subscribe to shares of a company was treated to be a capital asset under section 2(14) of the ITA (relating to definition of the term capital asset).
  - In cases of other taxpayers, the Revenue had accepted the fact that on cashless exercise of option, there arose an income in the nature of capital gains. Nothing was brought to the HC's notice that the view taken by the Income-tax Appellate Tribunal (ITAT) in earlier cases[4] was challenged by the Revenue.

    The SC in an earlier case[5] had held that it was not open for the Revenue to take one stand in case of the taxpayer and to challenge the correctness of the same in case of any other taxpayer.
- The HC held that the stock option being a right to purchase, the shares underlying the options were a capital asset in the hands of the taxpayer. The cashless exercise of option therefore was a transfer of capital asset by way of a relinquishment / extinguishment of right in capital asset.

  Further, the Revenue could not be permitted to take a different view (from that taken by the ITAT in earlier cases which was not challenged by the Revenue) in the appeal under consideration.

Based on the above, the HC held that as there was no employer-employee relationship between the taxpayer and the company granting the options, the gain on exercise of the cashless exercise of stock options was subject to tax as capital gains (and not as income from salary).

---

[2] CIT v. L.W. Russel [1964] 53 ITR 91 (SC)

[3] Miss Dhun Dadabhoy Kapadia v. CIT [1967] 63 ITR 651 (SC)

4 Kamlesh Bahedia v. ACIT [2014] 50 taxmann.com 236 (Delhi ITAT), N.R. Ravikrishnan v. ACIT [2019] 102 taxmann.com 418 (Bangalore ITAT), Dr. Muthian Sivathanu v. ACIT [2018] 100 taxmann.com 49 (Chennai ITAT)

5 Berger Paints India Ltd. v. CIT [2004] 266 ITR 99 (SC)

Comment:

This ruling reiterates the following:

- Unless the relationship of employer-employee exists, the income cannot be treated as salary.
- Right to subscribe to shares of a company is a capital asset and gain on cashless exercise of stock options is subject to capital gains tax (in case no employer-employee relationship exists).

Deloitte.