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Expenditure on employee stock options is deductible

The Karnataka High Court rendered its decision that discount on issue of employee stock option (i.e. difference between grant price and the market price of the shares as on the date of grant of options), is deductible.

Background:

- The taxpayer¹ is a company engaged in the business of manufacture of enzymes and pharmaceuticals ingredients.
- The taxpayer had floated a scheme viz. Employees Stock Option Plans (ESOP) and had constituted a Trust under a scheme.

The shares of the taxpayer were transferred to the Trust at face value (FV) and the employees were allowed to exercise the option to buy the shares within the time prescribed under the scheme, subject to terms and conditions mentioned therein. The taxpayer claimed the difference between market price and allotment price as a discount and claimed the same as an expenditure under section 37 of the Income tax Act, 1961 (ITA) in its income-tax return for the Financial Year 2003-04, corresponding to Assessment Year (AY) 2004-05.

However, for the AY 2009-10 onwards, the Assessing Officer had permitted the deduction of ESOP expenses.

As per section 37(1) of the ITA, any expenditure (not being expenditure of the nature described in sections 30 to 36 of the ITA) and not being in the nature of capital expenditure or personal expenses of the assessee, laid out or expended wholly and exclusively for the purposes of the business or profession is allowed in computing the income chargeable under the head "Profits and gains of business or profession".

Section 2(15) of the Companies Act, 1956 (CoA) (now Companies Act, 2013) defines employee stock option to mean option given to whole time directors, officers or the employees of the company, purchase or subscribe at a future date the securities offered by the company at a pre-determined price.

- The Assessing officer (AO) during the course of audit proceedings for AY 2004-05 rejected the taxpayer's claim of difference between market price and allotment price as an expenditure under section 37 of the ITA, on the ground that the taxpayer had not incurred any expenditure and the expenditure was contingent in nature.

¹ CIT v. Biocon Ltd (ITA no 653 of 2013) (Karnataka HC)

- The matter in the course of appeal proceedings reached the Karnataka High Court.

Decision of the High Court (HC):

- The HC noted that the only issue which arose for consideration in appeal under consideration was whether the Income-tax Appellate Tribunal (ITAT) was correct in holding that discount on issue of ESOP's (i.e. difference between the grant price and the market price) as on the date of grant of options was allowable as a deduction under section 37(1) of the ITA.
- The HC noted that in the current facts of the case, the ESOP's vested on an employee over a period of four years i.e. at the rate of 25%, which meant at the end of first year, the employee had a definite right to 25% of the shares and the taxpayer was bound to allow the vesting of 25% of the options.
- Taking a note of the above, the provisions of section 37(1) of the ITA and of section 2(15) of the CoA, the HC held that:
 - Section 37(1) of the ITA permitted deduction for the expenditure laid out or expended and did not contain a requirement that there should be a pay-out. If an expenditure was incurred, provision of section 37(1) of the ITA would be invoked and the said section did not envisage incurrence of expenditure in cash.
 - In an ESOP, a company undertakes to issue shares to its employees at a future date at a price lower than the current price. The employees are given stock option at discount (i.e. difference between the market price of shares at the time of grant of option and the offer price).
 - In order to be eligible for acquiring shares under the scheme, the employees are under an obligation to render their services during the vesting period as provided in the scheme.
 - On completion of the vesting period in the service of the company, the options vest with the employees.
 - The primary object of the issue of shares at a discount was not to waste capital but to earn profits by securing consistent services of the employees and could not be construed as short receipt of capital.
 - The expression "expenditure" would also include a loss and therefore, issuance of shares at a discount where the taxpayer absorbs the difference between the issue price and the market price would also be expenditure incurred for the purpose of section 37(1) of the ITA.
 - The ITAT had rightly placed reliance on earlier decisions² of the SC and held that the discount on issue of ESOP was not a contingent liability but an ascertained liability.
 - The deduction of discount on ESOP over the vesting period was in accordance with the books of account, prepared in accordance with Securities and Exchange Board of India (Employee Stock option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

² Bharat Earth Movers v. CIT [2000] 112 Taxman 61 (SC); Rotork Controls India Pvt Ltd v. CIT [2009] 180 Taxman 422 (SC)

- From AY 2009-10 onwards, the AO had permitted the deduction of ESOP expenses. An earlier decision³ had laid down the principle that revenue could not be permitted to take a different stand.

In view of the above, the HC answered the substantial question of law in favour of the taxpayer [viz. discount on issue of ESOP's (i.e. difference between the grant price and the market price) as on the date of grant of options was allowable as a deduction under section 37(1) of the ITA] and dismissed the Revenue's appeal.

Comment:

The issue relating to deduction of ESOP expenditure has been subject matter of litigation. This ruling lays down an important principle that discount on issue of ESOP (i.e. difference between grant price and the market price of the shares as on the date of grant of options) is deductible. The said ruling will provide clarity and relief to taxpayers.

³ Radhasoami Satsang v. CIT [1992] 193 ITR 321 (SC)



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