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Tax alert: One-time voluntary payment in relation to ESOP, a capital receipt, not a taxable perquisite

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The Delhi High Court has rendered its decision that one-time voluntary payment in the form of compensation for diminution in value of unexercised employee stock options (ESOPs) would be capital receipt and not taxable as 'perquisite', under section 17(2)(vi) of the Income-tax Act, 1961

In a nutshell

Determination, as to whether a particular receipt would tantamount to a capital receipt or revenue receipt, is dependent upon the factual scenario of a particular case.

Unless the charging section of the ITA elucidates any monetary receipt as chargeable to tax, the Revenue cannot proceed to charge such receipt as revenue receipt and that too on the basis of the manner or nature of payment, as understood by the deductor.

For an income to be included in the inclusive definition of 'perquisite', it is essential that it is generated from the exercise of options, by the employee.

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Background:

- The taxpayer[1] is an ex-employee of an Indian company (I Co). The I Co was a wholly owned subsidiary of another Indian company (A Co) and A Co in turn was the wholly-owned subsidiary of a Singapore based company [F Co].
- In 2012, the F Co rolled out an Employee Stock Option Plan (ESOP) called as 'FSOP', wherein, the F Co granted certain stock options to eligible persons, including employees of its subsidiaries. As per the clauses of FSOP, the taxpayer was granted certain stock options on and from November 2014 to November 2016 with a vesting schedule of 4 years.
- In December 2022, F Co announced the disinvestment of its another wholly owned subsidiary (P Co). Thereafter, the value of the stock options of F Co fell, pursuant to the disinvestment and subsequent remittances to the shareholders of F Co on account of dividend payments, buy-back, etc.
- Consequently, in April 2023, the taxpayer received a communication from F Co stating that as a **one-time measure**, F Co had decided to grant the option holders certain payment (per option) as compensation towards loss in the value of the options and it was based on the number of options held by the taxpayer as on a particular date. Furthermore, it was also stated that the F Co would be withholding tax (TDS) on the said compensation.
- Subsequently, the taxpayer preferred a withholding tax application under section 197 of the Income-tax Act, 1961 (ITA) [relating to certificate of lower rate or no deduction of tax] seeking a 'Nil' declaration certificate on the deduction of TDS by F Co.
- Against the taxpayer's application, the Assessing Officer (AO) passed an order rejecting the taxpayer's application on the grounds that the amount received would be chargeable to tax as 'perquisites' under section 17(2)(vi) of the ITA [relating to taxation of perquisites chargeable to tax under the head 'Income from Salary'].
- Aggrieved, the taxpayer filed a writ petition before the Delhi High Court (HC).

Relevant provisions in brief:

Extracts of Section 17(2)(vi) of the ITA:

"Salary", "perquisite" and "profits in lieu of salary" defined.

Section 17. For the purposes of Sections 15 and 16 and of this section

(1) ……

(2) "Perquisite" includes— ……..,

[(vi) the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

……..

Explanation.— For the purposes of this sub-clause,—

(a) "specified security" means the securities as defined in clause (h) of Section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and, where employees' stock option has been granted under any plan or scheme therefor, includes the securities offered under such plan or scheme;

[1] [2024] W.P. (C). 11155/2023 (Delhi- HC)

(b) "sweat equity shares" means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called;

(c) the value of any specified security or sweat equity shares shall be the fair market value of the specified security or sweat equity shares, as the case may be, on the date on which the option is exercised by the assessee as reduced by the amount actually paid by, or recovered from the assessee in respect of such security or shares;

(d) "fair market value" means the value determined in accordance with the method as may be prescribed;

(e) "option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price"

Decision of the HC:

The HC noted that the controversy in the case under consideration was whether the one-time payment made by F Co to the taxpayer, formed a part of its salary income under section 17(2)(vi) of the ITA, or not?

In this regard, the HC noted / observed as follows:

Perquisites under section 17(2) of the ITA

- 'Perquisites' under section 17(2) of the ITA, constitute a list of benefits or advantages, which are made taxable and are incidental to employment and received in excess of salary.
- As per section 17(2)(vi) of the ITA, 'perquisite' refers to value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the taxpayer.
- The explanation appended to section 17(2)(vi) of the ITA clarifies that the value of any specified security shall be the difference in the amount of fair market value of the specified security **on the date on which the option was exercised** and the actual amount paid by the taxpayer.

Capital vs revenue receipt

The Supreme Court (SC) in earlier rulings[2] had held / observed that:

- The determination as to whether a particular receipt would tantamount to a capital receipt or revenue receipt was dependent upon the factual scenario of a particular case.
- One-time voluntary cash allowance given to the taxpayer was a capital receipt and thus, not liable to tax.
- One-time payment was given to the taxpayer company in lieu of a change in contractual terms between the taxpayer company and the management company. In light of such facts, such monetary receipts were clubbed under the head of capital receipt and not under the revenue receipts and thus, not liable to tax.

Clause related to F Co to deduct tax on such compensation

- The AO's order also hinged upon the fact that since F Co intended to deduct tax before making the payment, therefore, the amount was liable to be taxed. The manner or nature of payment, as understood by the deductor, would not determine the taxability of such transaction. It is the quality of payment that determines its character and not the mode of payment.

[2] CIT v. Saurashtra Cement Ltd (2010) 11 SCC 84 (SC), Shrimant Padmaraje R. Kadambande v CIT (1992) 3 SCC 432 (SC) and Godrej and Co. v. CIT 1959 SCC OnLine SC 101 (SC)

- Unless the charging section of the ITA elucidated any monetary receipt as chargeable to tax, the Revenue could not proceed to charge such receipt as revenue receipt and that too on the basis of the manner or nature of payment, as understood by the deductor. This was also settled in an earlier SC ruling[3].

Taxability of the compensation paid

- A literal understanding of Explanation (c) to section 17(2)(vi) of the ITA would provide that the value of specified securities or sweat equity shares was dependent upon the **exercise of option by the taxpayer**. Therefore, for an income to be included in the inclusive definition of 'perquisite', it was essential that it was generated from the **exercise of options**, by the employee.
- The facts of the case under consideration suggested that the taxpayer did not exercise his options under the FSOP. The stock options were merely held by the taxpayer and the same had not been exercised and thus, they did not constitute income chargeable to tax in the hands of the taxpayer as none of the contingencies specified in section 17(2)(vi) of the ITA had occurred.
- Also, the compensation was a voluntary payment and not transfer by way of any obligation.

Reasoning behind the compensation paid

- The payment in question was not linked to the employment or business of the taxpayer, rather it was a one-time voluntary payment to all the option holders of FSOP, pursuant to the disinvestment of P Co's business from F Co.
- In the case under consideration, even though the right to exercise an option was available to the taxpayer, the amount received by him did not arise out of any transfer of stock options by the employer and it was a one-time voluntary payment not arising out of any statutory or contractual obligation.

In view of the above, the HC held that the AO's order holding that the one-time amount tantamounted to perquisite under section 17(2)(vi) of the ITA, could not be countenanced in law, as the stock options were not exercised by the taxpayer and the amount paid was one-time voluntary payment made by F Co to all option holders in lieu of disinvestment of P Co's business.

Accordingly, the HC set aside the AO's order.

Comments:

Employees often receive ESOPs (stock options) from the employer or parent company of the employer, being part of a multinational group. Where the exercise price of ESOPs is less than the fair value, then, the income is chargeable to tax as 'perquisite' under section 17(2)(vi) of the ITA.

In the case under consideration, apart from ESOPs, parent group company paid the taxpayer compensation for loss in value of the ESOPs. Hence, a question arose on the taxability of such one-time voluntary compensation paid to the employee/ESOP holders.

The HC in this ruling, while specifically dealing with the taxability of such one-time compensation payment to a taxpayer, has reiterated / held the following principles:

- Determination as to whether a particular receipt would tantamount to a capital receipt or revenue receipt is dependent upon the factual scenario of a particular case.
- Unless the charging section of the ITA elucidates any monetary receipt as chargeable to tax, the Revenue cannot proceed to charge such receipt as revenue receipt and that too on the basis of the manner or nature of payment, as understood by the deductor.

[3] Empire Jute Co. Ltd. v. CIT (1980) 4 SCC 25

- For an income to be included in the inclusive definition of ‘perquisite’, it is essential that it is generated from the exercise of options, by the employee.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

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