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Tax alert: One-time voluntary payment in relation to ESOP taxable, as perquisite

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The Madras High Court has rendered its decision that one-time voluntary payment in the form of compensation in relation to diminution in value of unexercised employee stock options (ESOPs) would be taxable as 'perquisite' under section 17(2)(vi) of the Income-tax Act, 1961.

In a nutshell

The term 'specified security' under explanation (a) to section 17(2)(vi) of the ITA , is not confined to **allotted** shares, but includes securities **offered** to the holder of ESOPs. The use of **'includes'** instead of **'means'** also indicates that the phrase "securities offered under such plan or scheme" is not intended to be exhaustive.

The expression "value of any specified security... transferred directly or indirectly by the employer ... free of cost or at concessional rate to the assessee" under section 17(2)(vi) of the ITA is broad enough to encompass the discretionary compensation paid to ESOP holders to compensate for the potential or actual diminution in value thereof.

In view of the inclusive definition of perquisite, merely because the method of valuing the perquisite does not fit neatly into explanation (c) to section 17(2)(vi) of the ITA, does not mean it cannot be taxed under the sub-head perquisites of the head "salaries" provided the value of the perquisite can be determined under section 17(2)(vi).

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Background:

- The taxpayer[1] is an employee of an Indian company (I Co). The I Co is a wholly owned subsidiary of a Singapore company (A Co). A Co, in turn is a wholly owned subsidiary of another Singapore based company (F Co).
- In 2012, F Co rolled out an Employee Stock Option Plan (ESOP) called as 'FSOP', wherein, F Co granted certain stock options to eligible persons, including employees of its subsidiaries. The expression 'subsidiaries' was also defined in FSOP as meaning all companies owned and controlled by F Co.
- In December 2022, F Co announced the disinvestment of its another wholly owned subsidiary (P Co). Consequently, in April 2023, F Co announced compensation in view of the divestment and described such payment as being made although there was no legal or contractual right thereto under the FSOP.
- 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 payable to all option grantees as on the record date in December 2022, whether current or former stakeholders, in respect of vested options, whereas in respect of options that had not vested, compensation was payable only to current stakeholders. The taxpayer had not exercised the option in respect of the vested ESOPs.
- Such compensation was paid to the taxpayer by deducting tax at source under section 192 of the Income-tax Act,1961 (ITA) by treating it as income under the head 'Salary'.
- On the basis that the amount received as compensation was a capital receipt, which is not liable to income-tax, the taxpayer applied for a 'Nil' tax deduction certificate under section 197 of the ITA [relating to certificate of lower rate or no deduction of tax].
- The Assessing Officer (AO) rejected the taxpayer's application on the grounds that there was a capital gain arising out of transfer of a capital asset, taxable under section 45 of the ITA [charging section for capital gains].
- Aggrieved, the taxpayer filed a writ petition before the Madras High Court (HC), wherein the taxpayer contended that:
  - Since the ESOPs held by the taxpayer were not transferred, there was no transfer of capital assets.
  - The ITA does not prescribe a computational mechanism for calculating capital gains tax in respect of the one-time discretionary compensation received by the taxpayer.
  - In the absence of a specific tax rate, capital gains tax could not be imposed on the transaction.
  - Since, the compensation received by the taxpayer was a capital receipt, which was not from the transfer of a capital asset, it could not be treated as income under any provisions of the ITA.

Relevant provisions in brief:

Extracts of Sections 2(14) and 17(2)(vi) of the ITA:

Section 2(14):

"(14)"capital asset" means—

(a) property of any kind held by an assessee, whether or not connected with his business or profession;"

Explanation 1—For the removal of doubts, it is hereby clarified that "property" includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever;"

[1] [2024] W.P. No. 26506/2023 (Madras- HC)

Section 17(2):

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

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

…(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;…

…(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;

Decision of the HC:

The HC noted / observed as follows:

- The FSOP provided for the grant of Stock Options and confers on an Option Grantee the right (but not the obligation) to exercise the Option upon the vesting thereof, and thereby receive shares of the issuing company, F Co, at a pre-determined price.
- In effect, the FSOP conferred rights in relation to shares, albeit exercisable subject to the terms and conditions specified therein. Being rights by way of options, the Option Grantee could choose not to exercise the Option upon the vesting thereof.
- The FSOP also provided for cancellation of both vested and unvested Options on the occurrence of specified events.

Nature of ESOPs under the ITA – whether capital asset?

- Capital asset is defined under section 2(14) of the ITA.
- Shares are indisputably capital assets because they qualify as movable goods under the Sale of Goods Act, 1930 and the Companies Act, 2013 (CA 2013) and, consequently, fall within the scope of the expression "any property" under section 2(14) of the ITA.

  ESOPs, by contrast, are rights in relation to capital assets, i.e. rights to receive capital assets (shares) subject to the terms and conditions of the ESOP scheme. Since the taxpayer had no rights in the Indian company of which he was an employee (other than as an employee), Explanation 1 was also not attracted.
- ESOPs and, in particular, the Stock Options in the case under consideration – were contractual rights to receive shares subject to the exercise of the option in terms of the applicable scheme. Only in case of breach of the obligation by the issuer to allot shares upon exercise of the Option in terms of the FSOP, the taxpayer had the right to claim compensation or, arguably, to sue for specific performance.
- ESOPs are, therefore, contractual rights that may qualify as actionable claims (albeit not as defined in the Transfer of Property Act, 1882) or *choses in action* in certain circumstances. ESOPs are not a source of revenue or profit-making apparatus for the holder because these actionable claims were, intrinsically, not capable of generating revenue (notional or actual) and could not be monetised, whether by transfer or otherwise, until shares were allotted.

- Even at the time of allotment, there is notional but not actual benefit. Actual benefit accrues only upon transfer provided there is a capital gain.
- The compensation was not paid for relinquishment of ESOPs or of the right to receive shares as per the FSOP. In fact, the taxpayer retained all the ESOPs and the right to receive the same number of shares of F Co subject to Vesting and Exercise.
- In view of above, ESOPs did not fall within the ambit of the expression **'property of any kind held by an assessee'** under section 2(14) of the ITA and were, consequently, not capital assets. Therefore, the compensation was not a capital receipt.

Whether ESOPs qualify as 'perquisite'?

- Under the ITA, 'salary' is defined inclusively to include 'perquisites' and 'perquisite' is also defined inclusively as covering the value of a specified security.
- The expression 'specified security' is defined exhaustively as securities as defined in section 2(h) of the Securities Contracts (Regulation) Act, 1956 [SCRA] and, in the context of ESOPs, as including securities offered under such plan or scheme.
- The expression "employees stock option" is defined under section 2(37) of the Companies Act 2013 [CA 2013], as "...the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price".
- Thus, the ESOPs granted to the taxpayer as an employee of a stepdown subsidiary qualified as ESOPs under the CA 2013 and, consequently, fell within the scope of Explanation (a) to section 17(2)(vi) of the ITA.

Delhi High Court (HC) ruling on similar issue

- The Delhi HC in an earlier ruling[2] had considered a case where the AO had rejected the application of 'nil' certificate of tax deduction at source. It was held in the order of rejection that compensation paid for the diminution in the fair value of underlying shares was taxable as a perquisite.
- The Delhi HC concluded that the one-time voluntary payment was a capital receipt, which was not liable to tax as a perquisite.

Whether discretionary compensation paid to ESOP holders is perquisite?

- Section 17(2)(vi) of the ITA takes within its fold and treats as a perquisite the benefit extended to the employee or any other person from and out of the grant of specified securities at concessional rates or free of cost.

  Explanation (a) to the said section 17(2)(vi) of the ITA explains the scope of 'specified security' by using the expression 'includes the securities **offered** under such plan or scheme'. The phrase 'includes the securities **allotted** under such plan or scheme' is not used.

  The inference that follows is that 'specified security', in the context of ESOPs, is not confined to allotted shares, but includes securities offered to the holder of ESOPs. The use of **'includes'** instead of **'means'** also indicates that the phrase "securities offered under such plan or scheme" is not intended to be exhaustive.
- Section 17(2)(vi) of the ITA refers to the value of the 'specified security' (in the case under consideration, value of the ESOP). Pursuant to communication on divestment in P Co, discretionary compensation was paid to restore status quo ante as regards the value of the ESOP.
- The expression *"value of any specified security... transferred directly or indirectly by the employer ... free of cost or at concessional rate to the assessee"* in section 17(2)(vi) of the ITA is broad enough to encompass the

[2] [2024] 163 taxmann.com 116 (Delhi HC).

discretionary compensation paid to ESOP holders to compensate for the potential or actual diminution in value thereof.

- Consequently, especially in view of the **inclusive** definition of perquisite, merely because the method of valuing the perquisite does not fit into Explanation (c) to section 17(2)(vi) of the ITA, does not mean it cannot be taxed under the sub-head perquisites of the head "salaries" provided the value of the perquisite can be determined under section 17(2)(vi).
- In order to determine the value of the perquisite as per section 17(2)(vi) of the ITA, one should be in a position to ascertain the benefit that the employee or other person received from the specified security, albeit not by way of capital gains.

Whether the compensation received by the taxpayer can be valued and taxed as a 'perquisite'?

- Explanation (c) to section 17(2)(vi) of the ITA prescribes that the value of the specified security is the difference between the fair market value of the shares on the date of exercise of the option and the price paid by the option holder. Unusually, in the current case, the taxpayer received a substantial monetary benefit at the pre-exercise stage by way of discretionary compensation for diminution in value of the Stock Options.

Whether the value of the perquisite can be determined?

- No payments were made by the taxpayer under the FSOP as on the record date. Nonetheless, by qualifying as an Employee under the FSOP, the taxpayer received compensation on all ESOPs (both Vested and Unvested) held by him as on the record date.
- The Supreme Court (SC) in an earlier ruling[3], had laid down the principle that the benefit from the ESOP is to be determined for purposes of, and as a pre-requisite for, taxation as a perquisite.
- In the case under consideration, actual monetary benefit was received at the pre-exercise stage by the taxpayer and other stakeholders. Such monetary benefit was undoubtedly paid to the taxpayer on account of being an ESOP holder on all ESOPs held by him.
- These ESOPs were clearly granted to the taxpayer as an Employee under the FSOP. If payments had been made by the taxpayer in relation to the ESOPs, it would have been necessary to deduct the value thereof to arrive at the value of the perquisite. Since the taxpayer did not make any payment towards the ESOPs and continued to retain all the ESOPs even after the receipt of compensation, the entire receipt qualified as perquisite and became liable to be taxed under the head "salaries".

In view of the above, the HC held that the compensation qualified as a perquisite and not a capital receipt. Hence, the taxpayer was not entitled to a 'nil' certificate of deduction.

Comments:

Employees may 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, parent group company paid the taxpayer one-time voluntary compensation for loss in value of the ESOPs and therefore, controversy arose as to whether such compensation would be taxable capital gains or perquisite in the hands of the employee.

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:

[3] Commissioner of Income Tax, Bangalore v. Infosys Technologies Ltd. (2008) 297 ITR 167 (SC)

- ESOPs do not fall within the ambit of the expression **'property of any kind held by an assessee'** under section 2(14) of the ITA and are, consequently, not capital assets. Therefore, the compensation is not a capital receipt.
- The term 'specified security' under Explanation (a) to section 17(2)(vi) of the ITA , is not confined to **allotted** shares, but includes securities **offered** to the holder of ESOPs. The use of **'includes'** instead of **'means'** also indicates that the phrase "securities offered under such plan or scheme" is not intended to be exhaustive.
- The expression *"value of any specified security... transferred directly or indirectly by the employer ... free of cost or at concessional rate to the assessee"* under section 17(2)(vi) of the ITA is broad enough to encompass the discretionary compensation paid to ESOP holders to compensate for the potential or actual diminution in value thereof.
- In view of the **inclusive** definition of perquisite, merely because the method of valuing the perquisite does not fit neatly into explanation (c) to section 17(2)(vi) of the ITA, does not mean it cannot be taxed under the sub-head perquisites of the head "salaries" provided the value of the perquisite can be determined under section 17(2)(vi).
- In order to determine the value of the perquisite as per section 17(2)(vi) of the ITA, one should be in a position to ascertain the benefit that the employee or other person received from the specified security, albeit not by way of capital gains.

It is pertinent to note that the Madras High Court in this case has considered the findings of the recent ruling[4] of the Delhi HC ruling on similar issue. Please refer to our tax alert on the earlier Delhi HC below:

https://www2.deloitte.com/in/en/pages/tax/articles/tax-alert-one-time-voluntary-payment-in-relation-to-esop.html

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

[4] [2024] 163 taxmann.com 116 (Delhi HC).

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