

## Direct Tax Alert

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## High Court of Karnataka affirms the ruling of Special Bench of Tribunal, allows discount on issue of Employee Stock Options as revenue expenditure<sup>1</sup>

### Background

- The assessee company ('the Company') had floated a scheme of stock options for its employees ('ESOP'). A trust had been constituted under the scheme.
- The shares of the Company were transferred to the trust at face value and the employees of the Company were allowed to exercise the option to buy the shares of the Company from the trust within the prescribed time subject to applicable terms and conditions under the scheme.
- The Company claimed the amount of discount i.e. the difference between market price of shares as on the date of grant of options and the exercise price as an expenditure under

section 37 of the Income-tax Act, 1961 ('the Act').

- The tax department disallowed the claim of the Company on the ground that the Company did not incur any expenditure and ESOP discount represented a contingent liability since there is no certainty of options getting vested in the employees and/or employees exercising the options.
- The first appellate authority upheld order of the tax department. The Company appealed against the order of the appellate authority before the Tribunal.
- The division bench of the Income-tax Appellate Tribunal ('Tribunal') referred the case to the

<sup>1</sup> Biocon Ltd. (I.T.A. No. 653 of 2013)

Bangalore Bench (Special) of the Tribunal ('the Special Bench') in view of conflicting decisions between different benches of the Tribunal.

- In this regard, the Special Bench had held as under –

#### **a) Discount during vesting period**

- ESOP discount being the amount of difference between the market value of shares on the date of grant of options and the exercise price at which shares were allotted to employees is in nature of consideration for employment.
- Such discount is thus allowable as an expenditure under Section 37 of the Act over the vesting period at the rate at which there is vesting of options in the employees.

#### **b) Subsequent adjustment to discount**

- It is the market price at the time of the grant of options which is considered for working out the amount of discount during the vesting period.
- However, since actual amount of employee cost can be precisely determined only at the time of the exercise of option by the employees, the provisional amount of discount availed as deduction during the vesting period needs to be adjusted in the light of the actual discount on the basis of the market price of the shares at the time of exercise of options.
- Since the remuneration to the employees under the ESOP is the amount of discount with respect to the market price of shares at the time of exercise of option, the employee

cost in the hands of the company should also be with respect to the same base.

- The Revenue filed an appeal before the High Court of Karnataka ('High Court') against the order of Special Bench.

#### **Issue for consideration before the High Court**

The High Court admitted the appeal of Revenue with the following questions of law-

- Whether ESOP discount is allowable deduction in computing the income under the head 'Profits and Gains of Business or Profession'?
- Whether difference between market price of the shares at the time of grant of option and offer price amounts to discount and the same has to be treated as remuneration to the employees for their continuity of service?
- Whether the Tribunal committed an error in not examining the scheme of ESOP from which it is clear that the employees will not get any right in the shares till completion of the period prescribed and the expenditure claimed is contingent?

#### **High Court Ruling**

The High Court upheld the questions in favour of the Company. It affirmed the ruling of the Special Bench thereby observing the discount on issue of ESOPs as a deductible expenditure under section 37 of the Act. The key observations of the High Court are as under.

#### **No requirement of pay out in cash for claiming deduction under section 37(1)**

- Section 37(1) of the Act permits deduction for the expenditure laid out or expended and

does not contain a requirement that there has to be a pay-out.

- If an expenditure has been incurred, provisions of section 37(1) of the Act would be attracted. Section 37 does not envisage incurrence of expenditure in cash.

### **ESOP Discount represents ascertained liability and is not a contingent liability**

- It is well settled in law that if a business liability has arisen in the accounting year, the same is permissible as deduction, even though, liability may have to be quantified and discharged at a future date.
- On exercise of option by an employee, the actual amount of benefit that needs to be determined is only a quantification of liability which takes place at a future date. Discount on issue of ESOPs is not a contingent liability; rather it is an ascertained liability.
- The Company has incurred a definite legal liability and on following the mercantile system of accounting, the discount on ESOPs has rightly been debited as expenditure in the books of account. The High Court agreed with the view taken in PVP Ventures Ltd<sup>2</sup> And Lemon Tree Hotels Ltd<sup>3</sup> wherein ESOP discount was allowed as revenue expenditure.

### **Expenditure includes 'loss'**

- The expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount where the Company absorbs the difference between the price at which the shares are issued and the market value of the

shares would also be expenditure incurred for the purposes of section 37(1) of the Act.

### **ESOP Discount does not represent short receipt of capital**

- The primary object of the ESOP exercise is not to waste capital but to earn profits by securing consistent services of the employees and the same cannot be thus construed as short receipt of capital.

### **Deduction over vesting period is in accordance with accounting treatment followed**

- Deduction of discount on ESOPs over the vesting period is in accordance with the accounting in the books of account, which have been prepared in accordance with Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

### **Aurtus comments**

- ESOP is a prevalent method of remunerating and retaining key employees in an organization. The above ruling of the High Court follows the trend of favourable rulings of other High Courts allowing deduction of discount on issue of ESOPs as business expenditure.
- The decision of the High Court of Karnataka is in a way in line with the decision of High Court of Delhi and High Court of Madras thereby affirming the deduction of discount on ESOPs over the vesting period, which is in accordance with the accounting treatment in the books,

<sup>2</sup> CIT v. PVP Ventures Ltd. [2012] 23 taxmann.com 286 (Madras)

<sup>3</sup> CIT v. Lemon Tree Hotels Ltd. [2019] 104 taxmann.com 26 (Delhi)

prepared in accordance with the SEBI Guidelines. In case of unlisted companies which are not required to follow SEBI guidelines, the quantum of deduction ought to be on the basis of the amount debited in the books of account as per the applicable Accounting Standards and Guidance Note on accounting for employee share-based payments.

- Further, in addition to the issue of deductibility of ESOP discount over the vesting period, the Special Bench had also dealt with the issue of subsequent adjustment to ESOP discount arising at the time of exercise of options by the employees. The Special Bench had held that subsequent adjustment (upward or downward) with respect to difference between market price as on the date of exercise of options and market price as on the date of grant should

also be taken into account for computing taxable income in subsequent years when the options are exercised by the employees. The Special Bench had remarked that since the remuneration to the employees under the ESOP is the amount of discount with respect to the market price of shares at the time of exercise of option, the employee cost in the hands of the company should also be with respect to the same base. This aspect has however not been dealt with in the High Court ruling since the question of law for consideration before the High Court was limited to allowability of difference between market price at the time of grant of options and exercise price as deduction under the Act. In absence of the ruling of High Court on this issue, validity of such proposition remains to be tested before higher forums.

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