



The difference between the market price and the issue price of the shares offered to employees under the stock option scheme is not an allowable expenditure

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Ranbaxy Laboratories Ltd. has held that the difference between the market price and the issue price of the shares offered to employees under the Employee Stock Option Scheme (ESOP) is not an allowable expenditure since the loss incurred due to issue of shares at a discount is a notional loss and such notional loss cannot be considered as an allowable expenditure under the provisions of the Income-tax Act, 1961 (the Act). Though it was mandatory to record it as an expenditure as per the Securities Exchange Board of India (SEBI) guidelines.

Facts of the case

- The taxpayer granted stock option of 332,250 shares to its employees under an Employee Stock Option Plan during the year. The vesting period of such ESOP was spread over five years. As per the scheme the shares were to be issued at INR 595 (exercise price) and the market price of the share on the date of grant was INR 738.95. The taxpayer treated the difference between the market price and the exercise price as employee compensation and the difference was charged to Profit and Loss Account (P & L A/c). The charge to P & L A/c was deferred over vesting period i.e. 5 years.
- The Assessing Officer (AO) disallowed the claim of the taxpayer on the ground that the said deduction was not permissible under the Act unless a liability has either been paid or arisen during the year.
- The Commissioner of Income-tax (Appeals) held that the liability will become a certain liability only when employees exercise their option by making payment of the offer price and get their share. Accordingly, the expenditure will be allowed only in the year in which the option will be exercised.

Issue before the Tribunal

- Whether the deferred expenditure charged to P & L A/c was allowable under the Act?

Contentions of the taxpayer

- ESOP is an employee compensation scheme intended to encourage a sense of belongingness and feeling of ownership in the employees, to create partnership with the employees for a transition from being mere 'employees' to 'stake holders' and such scheme was issued as per the SEBI guidelines.
- The liability of the taxpayer gets crystallised upon the grant of options to the employees since the option to exercise such grant was with the employees on which the taxpayer had no control.
- The liability of the taxpayer under the ESOP can be measured with reasonable certainty under the mercantile method of accounting as per the guidelines issued by the SEBI in that regard. Further, since the liability under the ESOP was a definite liability, it was an allowable expenditure.
- The liability under an ESOP was easily comparable with provision made for leave encashment and the Supreme Court in the case of Bharat Earthmovers¹ had held that provision made for leave encashment is an allowable expenditure.
- The SEBI guidelines also mandate the provision for the option discount as an allowable expenditure.
- The taxpayer also placed reliance on the decision of the SSI Ltd.² where the Chennai Tribunal had allowed the claim of the taxpayer under similar facts.

Contentions of the tax department

- The taxpayer incurred neither any expenditure nor liability at the time of agreeing to issue the shares at the discounted price and merely by grant of stock option the taxpayer did not incur any expenditure.
- The share premium received by the taxpayer was not the income of the taxpayer and the discount on the market price merely represents lesser realisation of the share premium by the taxpayer. Therefore, it was a notional loss to the extent of share premium forgone by the taxpayer.
- The SEBI guidelines are relevant for the purpose of accounting or presentation of financial statement in respect of listed company but

¹ Bharat Earthmovers v. CIT [2000] 245 ITR 428 (SC)

² SSI Ltd. v. DCIT [2004] 85 TTJ 1049 (Chen)

are not conclusive to determine the allowability of expenditure. The expenditure is allowable only when it is allowed by the Act.

Ruling of the Tribunal

- If the issue price to the employees would have been market price it would have resulted into a higher realisation of the share premium to the taxpayer but the share premium cannot be considered as income of the taxpayer. Accordingly, forgoing of the share premium also cannot result in loss of income to the taxpayer.
- Though the SEBI guidelines require the taxpayer to account for short receipt of share premium as employee compensation expenditure, the allowability of the expenditure should be determined as per the provisions of the Act.
- The loss incurred due to issue of shares at lesser than market price was a notional loss and such notional loss cannot be considered as an allowable expenditure under the provisions of the Act.
- To claim a deduction under the provision of section 37 of the Act there should be an expenditure which is incurred for business purpose. The Supreme Court in the case of Molasses Company Pvt. Ltd.³ and Nainital Bank Ltd.⁴ had held that expenditure means a spending of money in the sense of 'paid out or away' on an irretrievable basis.
- The Tribunal observed that in the case of Lowry (Inspector of Taxes) v. Consolidated African Selection Trust Ltd.⁵, under a similar set of facts, the House of Lords had held that loss due to issue of shares at discounted price was not an allowable expenditure. The loss was disallowed mainly on the following two grounds:
 - The amount of premium 'forgone' by the company was not a disbursement or expense and
 - The issue of shares by a limited company was not a trading transaction at all.
- The Tribunal also placed reliance on the decision of Supreme Court in the case of Eimco K.C.P. Ltd.⁶ where the Supreme Court held that the issue of shares by the taxpayer in lieu of contribution of technical know-how by a promoter was not an expenditure laid out for the purpose of business.
- The Tribunal observed that the facts in the case of SSI Ltd. were distinguishable. The Chennai Tribunal while deciding on the validity of the CIT's action to revise the order passed by the AO

³ Molasses Company Pvt. Ltd. v. CIT [1959] 37 ITR 66 (SC)

⁴ CIT v. Nainital Bank Ltd. [1966] 62 ITR 638 (SC)

⁵ Lowry (Inspector of Taxes) v. Consolidated African Selection Trust Ltd. [1940] 8 ITR 88 (House of Lords)

⁶ Eimco K.C.P. Ltd. v. CIT [2000] 242 ITR 659 (SC)

held that the discount offered to the employees was an ascertained liability and not a contingent liability. However, the Chennai Tribunal did not comment on the issue of whether the loss was notional in nature or not.

- Accordingly, the Tribunal held that the discount on the market price of the shares offered to the employees under ESOP was not an allowable expenditure.

Our Comments

The difference between the market price and the issue price of the shares offered to employees under the stock option scheme has not been allowed as expenditure since the loss incurred due to issue of shares at discount was a notional loss. It has also been held that even though it is mandatory to record it as expenditure as per the SEBI guidelines the same cannot be allowed under the Act.

It is important to note that in the past also the courts have not allowed such discount offered to employees under the stock option scheme. The Chennai bench of the Tribunal in the case of SSI Ltd. held that the discount offered to the employees was an ascertained liability and not a contingent liability. However, while distinguishing SSI Ltd's decision, the Delhi bench has observed that the Chennai Bench did not answer the issue whether or not such loss is notional in nature

Disclaimer

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

**For further information about KPMG in India and our services,
please contact:**

Bangalore

Maruthi Infotech Centre, 11-12/1
Inner Ring Road
Koramangala, Bangalore 560071
Phone: + 91 80 3980 6000 Fax: +91 80 3980 6999

Chennai

KPMG House
No.10, Mahatma Gandhi Road,
Nungambakkam High Road,
Chennai 600034
Phone: +91 44 39145000 Fax: +91 44 39145999

Delhi

DLF Cyber City, Building no. 10, Block B, Phase II
Gurgaon, Haryana 122 002
Phone: +91 124 307 4000 Fax: +91 124 254 9195

Hyderabad

KPMG, 8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad - 500 034
Phone: +91 40 30465000 Fax: + 91 40 30465299

Kolkata

KPMG Infinity Benchmark
Plot No. G-1, 10th floor Block - EP & GP,
Sector – V, Salt Lake City
Kolkata - 700091
Phone: +91 33 4403 4000 Fax: +91 33 4403 4199

Mumbai

KPMG House, Kamala Mills Compound, 448 Senapati Bapat Marg
Lower Parel, Mumbai 400 013
Phone: +91 22 39896000 Fax: + 91 22 39836000

Pune

703, 7th Floor Godrej Castlemaine, Next to Ruby Hall Clinic,
Bund Garden Road, Pune 411001
Phone: +91 20 30585764/65 Fax: +91 20 3058 5775

Kochi

4/F, Palal Towers, M. G. Road,
Ravipuram, Kochi 682016
Phone: +91 (484) 305 9000 Fax: +91 (484) 305 9001