



Gains on sale of shares allotted under cashless Employee Stock Option Plan are not taxable as capital gains

Background

The Income-Tax Appellate Tribunal, Mumbai¹ has held that in case no payment has been made for acquiring shares under Employee Stock Option Plan, the gain on sale of said shares should not be liable to capital gains tax. As the date of exercise of options and date of sale is same and further, there is no difference between the sale price and the deemed cost of acquisition, in any case, it is not short term capital gains.

Facts of the case

- Mr. Bomi S. Billimoria ('the employee') was an employee of Johnson & Johnson, India, which was a subsidiary of Johnson & Johnson, USA.
- In 1989, the employee was granted certain options under an Employee Stock Option Plan ('ESOP') of Johnson & Johnson USA.
- The Reserve Bank of India ('RBI') had approved the ESOP on the condition that there should not be any payment by the employee (whether in India or abroad) for acquiring the shares under the ESOP.
- In 1992, the employee exercised his right to realize the value of the options. On the date of exercise of options, the shares were sold in USA and the employee received the net proceeds.

Issues before the Tribunal

- Whether the gain arising from sale of the shares acquired under the ESOP was liable to be tax as capital gains (short-term capital gains or long-term capital gains)?

¹ Mr. Bomi S. Billimoria vs. A.C Cir 23(1), Mumbai (ITA No.2120/Mum/1998)

- Whether there is any cost of acquisition of the said shares for computing the capital gains tax?

The assessee's contention

- As per the condition laid down in the RBI approval, no payment was made at any point of time either in India or abroad for acquiring the shares under the ESOP. Accordingly there was no cost of acquisition of the shares.
- In view of the Supreme Court ruling², the gain on sale of shares cannot be taxed as capital gains as there was no cost of acquisition of the shares. The said gain being a capital receipt is not liable to tax.
- In the instant case, the shares were sold on the date of acquisition of shares pursuant to exercise of options. Therefore, there was no difference between the purchase price and sale price of shares. Accordingly, there cannot be any capital gains tax.

The Assessing Officer's (AO) contention

The profit arising on sale of the shares is liable to be taxed either as salary, short term capital gains or speculation profit in the hands of the employee.

The Commissioner of Income-tax (Appeals) [CIT (A)] decision

- The AO was not justified in considering the taxability of the gain under various head of incomes. The said gain was taxable as capital gains.
- The agency through whom the shares were sold had deducted the cost from the sale consideration. Therefore, it cannot be said that no cost was incurred by the employee. The facts of the case are distinguishable from the Supreme Court decision relied by the employee.
- The shares obtained under the ESOP were a capital asset. As the shares were held by the employee for less than three years, the said gain was liable to tax as short term capital gains.

The Tribunal's decision

- As per the ESOP and terms of the RBI approval, no payment was made by the employee for acquiring the shares.
- Applying the principle of the Supreme Court ruling relied on by the employee, the profit/ gain arising on sale of shares was not liable to tax as capital gains, as there was no cost of acquisition of the shares.

² CIT vs B.C. Srinivasa Setty (128 ITR 294)

- Even if it is assumed that the market value of the shares is the benefit given to the assessee, such benefit can be said to accrue to the assessee only on the date of exercise of the options.
- Further, as the date of acquisition and date of sale of the shares was same, there was no difference between the deemed cost of acquisition and sale consideration of the shares. Accordingly, there was no gain liable to capital gains tax.
- The Tribunal also noted that the tax provisions for ESOPs has undergone several amendments with a view to bring to tax the benefit available to an employee under various plans/schemes. However this issue was not raised before them and accordingly it was just a passing reference noted by the Tribunal.

Our Comments

This ruling reiterates that in case of an exer-sale i.e. where the sale date and the exercise date is the same and no payment has been made for acquiring the shares under ESOP (i.e. cashless ESOP), there would be no cost of acquisition of the shares. Accordingly, the gain on sale of said shares should not be liable to capital gains tax as the spread between the sale price and the price payable on exercise is nil.

This ruling pertains to a past tax year where the laws on taxation of ESOPs was not clear. Accordingly, this ruling does not discuss that if there is a difference between the fair market value on the date of exercise of options and the exercise price payable by the employee, there could be an element of perquisite taxation in the hands of the employee.

As per the current tax provisions, the difference between the fair market value on the date of exercise of options and the exercise price payable by the employee is subject to tax as salary income in the hands of the employee. The employer is also obliged to withhold tax at source on the same. Subsequently, on sale of shares the spread between the sale price and the fair market value on the date of exercise is subject to capital gains tax in the hands of the employee.

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