

TAX FLASH NEWS

9 December 2020

Discount on issue of shares under an ESOP scheme is allowed as a business expenditure

Recently, the Karnataka High Court in the case of Biocon Ltd.¹ (the taxpayer) dealt with the issue of allowability of discount on the issue of Employees Stock Option Plans (ESOPs) as a business expenditure. The High Court observed that the expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount where the taxpayer absorbs the difference between the price at which shares were issued and the market value of the shares would also be treated as an expenditure incurred for the purpose of Section 37(1) of the Income-tax Act, 1961 (the Act). Accordingly, the High Court held that the taxpayer is entitled to claim discount on issue of shares under the ESOPs as business expenditure under the provisions of Section 37.

Facts of the case

The taxpayer is engaged in the business of manufacture of Enzymes and Pharmaceuticals Ingredients. The taxpayer had floated ESOPs and constituted a trust under a scheme. The shares of the company were transferred to the trust at the face value and the employees of the taxpayer were allowed to exercise the option to buy the shares within the time prescribed under the scheme subject to terms and conditions mentioned therein.

During the Assessment Year (AY) 2004-05, the taxpayer claimed that the difference of market price and allotment price is a discount and it should be allowed as an expenditure under Section 37.

The Assessing Officer (AO) rejected the claim on the ground that the taxpayer had not incurred any expenditure and the expenditure was contingent in nature and therefore, the taxpayer was not entitled to claim the same as deduction under Section 37.

The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. However, the division bench of the Tribunal made a reference to the Special Bench of Tribunal in view of conflicting decisions on the issue.

The Special Bench of the Tribunal held in favour of the taxpayer and observed that the difference between the market value and the face value at which shares were allotted were part of remuneration, which were paid to the employees in order to compensate them for the continuity of their services to the company and therefore, the same was allowable as an expenditure under Section 37. Further the expenditure was not contingent in nature.

High Court decision

Section 37(1) permits deduction for the expenditure laid-out or expended and does not contain a requirement that there had to be a pay-out. If an expenditure had been incurred, provision of Section 37(1) would be attracted. Section 37 does not envisage incurrance of expenditure in cash. In the instant case, the ESOPs vest in an employee over a period of four years that is at the rate of 25 per cent, which means at the end of first year, the employee has a definite right to 25 per cent of the shares and the taxpayer is bound to allow the vesting of 25 per cent of the options. It is well settled in law that if a business liability had 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 has to be determined and that is only a quantification of liability, which takes place at a future date.

¹ DCIT v. Biocon Ltd. (ITA No. 653/Kar/2013, AY 2004-05) - Taxsutra.com

The Tribunal correctly relied on the decision of the Supreme Court in the case of Bharat Earth Movers² and Rotork Controls India Pvt Ltd³ and had recorded a finding that discount on issue of ESOPs was not a contingent liability but was an ascertained liability.

From perusal of Section 37(1), it was evident that the taxpayer was entitled to claim deduction if the expenditure has been incurred. The expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount where the taxpayer absorbs the difference between the price at which it was issued and the market value of the shares would also be expenditure incurred for the purpose of Section 37(1). The primary object of the aforesaid exercise was not to waste capital but to earn profits by securing consistent services of the employees and therefore, the same cannot be construed as short receipt of capital. The Bangalore Tribunal correctly held that incurring of the expenditure by the taxpayer entitles him for deduction under Section 37(1) subject to fulfillment of the condition. The deduction of discount on ESOP over the vesting period was in accordance with the accounting in the books of accounts, which had been prepared in accordance with SEBI (Employees Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

The decision in the case of Infosys Technologies Ltd⁴ relied on by the tax department is distinguishable on facts of the present case. Further, various decisions⁵ relied on by the tax department supports the case of the taxpayer that it had 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 accounts. The High Court concurred with the view of PVP Ventures Ltd⁶ and Lemon Tree Hotels Ltd⁷. The High Court also observed that from AY 2009-10 onwards, the AO had permitted the deduction of ESOP expenses and therefore relying on the decision of Radhasoami Satsang⁸ the tax department cannot be permitted to take a different stand with regard to the assessment year in question.

Our comments

The issue with respect to deductibility of discount arises on account shares offered under the ESOP scheme has been a subject matter of debate before the Courts/Tribunal.

The Courts/Tribunal in various cases⁹ have held that the difference between the market price and the issue price of shares under the ESOP is a deductible expenditure under the Act and such expenditure is on account of an ascertained (not contingent) liability. On the other hand some of the Courts/Tribunal¹⁰, have held that the difference between the market price and the issue price of the shares offered to employees under the ESOP scheme is not an allowable expenditure since the loss incurred due to issue of shares at a discount is a notional loss which cannot be considered as an allowable expenditure.

The Karnataka High Court in the present case has held that the difference between the market price and the issue price of shares under the ESOP scheme is a deductible expenditure under Section 37. The expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount where the taxpayer absorbs the difference between the price at which the shares were issued and the market value of the shares would also be treated as an expenditure incurred for the purpose of Section 37(1)



² Bharat Earth Movers v. CIT [2000] 245 ITR 428 (SC)

³ Rotork Controls India Pvt Ltd v. CIT [2009] 314 ITR 62 (SC)

⁴ CIT v. Infosys Technologies Ltd [2008] 297 ITR 167 (SC)

⁵ CIT v. A. Gajapathy Naidu [1964] 53 ITR 114 (SC), Morvi Industries Ltd. v. CIT (1971) 82 ITR 835 (SC) and Keshav Mills v. CIT [1953] 23 ITR 230 (SC)

⁶ CIT v. PVP Ventures Limited [2012] 23 taxmann.com 286 (Mad)

⁷ CIT v. Lemon Tree Hotels Ltd (ITA No. 107/2015) (Del)

⁸ Radhasoami Satsang v. CIT [1992] 193 ITR 321 (SC)

⁹ CIT v. PVP Ventures Limited [2012] 23 taxmann.com 286 (Mad), SSI Ltd. v. DCIT [2004] 85 TTJ 1049 (Chen), DCIT v. Kotak Mahindra Bank Ltd. (ITA No. 698/Mum/2016)

¹⁰ Ranbaxy Laboratories Limited v. ACIT [2009] 124 TTJ 771 (Del) and VIP Industries Ltd v. DCIT (ITA No. 7242/Mum/080)

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