KPMG

Tax Flash News

30 June 2025

KPMG. Make the Difference.

Compensation received for diminution in value of stock options is a capital receipt, not taxable

Executive summary

In the case of *Manjeet Singh Chawla*[1], the Karnataka High Court held that the compensation awarded to an employee due to the diminution in value of stock options is not chargeable to tax as salary or capital gains under the Income-tax Act, 1961 (the Act).

The Karnataka High Court relied on the Delhi High Court's decision in the case of *Sanjay Baweja*[2] and distinguished the Madras High Court decision in the case of *Nishithkumar Mukeshkumar Mehta*[3] which involved identical transaction relating to other employees of the same employer.

Facts of the case

The taxpayer was an employee of an Indian company (I Ltd).

I Ltd was a step-down subsidiary of a foreign company (F Ltd) which also held shares in multiple other subsidiaries.

---

[1] *Manjeet Singh Chawla* v. *DCIT of TDS* (Writ Petition No. 20212 of 2023 (T-IT))

[2] *Sanjay Baweja* v. *DCIT* [2025] 474 ITR 376 (Delhi)

[3] *Nishithkumar Mukeshkumar Mehta* v. *DCIT* [2025] 475 ITR 614 (Madras)

Under the group Employee Stock Option Plan (ESOP) of F Ltd, the taxpayer was granted stock options with a vesting schedule of four years - some of which had vested (but not exercised), while others remained unvested till the year under consideration.

F Ltd divested its stake in other subsidiaries leading to diminution in the value of the stock options held by employees. To compensate for this loss in value, F Ltd voluntarily offered a one-time compensatory payment to eligible option holders, including the taxpayer.

The taxpayer had neither exercised any of his stock options, nor had any shares been allotted or transferred to him. There was also no legal or contractual obligation on F Ltd to pay compensation to the taxpayer. The payment was entirely discretionary and extended to all eligible option holders - including existing employees, former employees, advisors, consultants, and employees of group companies.

Relying on the Delhi High Court judgment in the case of *Sanjay Baweja* (another employee of I Ltd), the taxpayer applied for Nil withholding certificate[4] arguing that one-time compensatory payment from F Ltd was capital receipt and did not constitute 'income' under the Act[5].

[4] Section 197
[5] Section 2(24)

However, the Revenue rejected the application, asserting that the compensation received from F Ltd was taxable as a perquisite and as capital gains arising on transfer of stock options exercised under ESOP.

Aggrieved by the Revenue's order, the taxpayer filed a writ petition[6] before the Karnataka High Court.

Relevant provisions

Shares allotted under stock options are taxable at two stages – firstly, as 'perquisite' at the time of allotment or transfer of shares pursuant to exercising of stock options and secondly, as 'capital gains' at the time of sale or transfer of allotted shares.

Section 17(2)(vi) of the Act includes within the definition of perquisite, the value of any specified security or sweat equity shares allotted or transferred by the employer (or former employer) to the employee, either free of cost or at a concessional rate. The perquisite value is the fair market value (FMV) of the security/ share on the date of exercise as reduced by the amount actually paid by, or recovered from, the employee.

[6] Issue relating to maintainability of writ petition is not covered in this note

Revenue's contentions

Receipt of any stock options under ESOP or ESOP-related monetary benefit by the taxpayer inherently carries the character of income and is taxable as perquisite.

Since the compensation was linked to reduction in value of stock options, the tax treatment of this compensation should be identical to the tax treatment of the stock options themselves.

There was a deemed/ implied allotment of shares, and the compensation paid to the taxpayer was part of the FMV of the shares issued under ESOP, to which the taxpayer is entitled to after the vesting period when he exercises the option[7].

Reliance was placed on the Madras High Court judgment in the case of *Nishithkumar Mukeshkumar Mehta* (another employee of I Ltd), which upheld the taxability of similar compensation as 'perquisite'.

[7] Explanation to Section 17(2)(vi)

High Court's Decision

Compensation was a capital receipt, not revenue

One-time voluntary compensatory payment was for the reduction in value of stock options, which formed part of the profit-making apparatus of the taxpayer i.e., his employment.

Compensation for termination or loss of a source of income was a capital receipt and therefore, not subject to tax under the Act[8].

The payment was made by F Ltd without any corresponding contractual obligation and considering that the number of stock options remained the same, the said compensation could not be classified as a revenue receipt.

Compensation not taxable as 'perquisite'

Stock options confer a right, and not an obligation, to purchase the underlying shares/ security. On vesting, the option holder acquires the right to exercise the option and get the allotment of shares. Taxability arises when the employee is allotted shares pursuant to exercising of the vested stock options or when the shares allotted to such employee are transferred,

[8] *Kettlewell Bullen & Co.Ltd.* v. *CIT* [1964] 53 ITR 261 (SC); *M/s. Karam Chand Thapar & Bros. Pvt. Ltd.* v. *CIT (Central), Calcutta* [1972] 4 SCC 124; *Oberoi Hotel (P) Ltd.* v. *CIT* [1999] 103 Taxmann 236 (SC); *Godrej & Co., Bombay v. CIT, Bombay* [1960] 1 SCR 527

thereby, taxable as capital gains. There is no tax incidence at the stage of vesting of stock option.

In the instant case, although some stock options had vested, the taxpayer had not exercised them, and no shares were allotted or transferred to him under the ESOP.

A voluntary one-time compensation payment towards the reduction in the value of stock option prior to exercise of option or the allotment of shares cannot be taxed as perquisite.

Even if such compensation is treated as 'perquisite', without allotment of shares, the computation mechanism for determining perquisite value fails[9], resulting in no tax incidence in the hands of the taxpayer.

Compensation not taxable as 'capital gains'

As the stock options were not exercised and no shares were allotted to the taxpayer, the cost of acquisition of stock options could not be determined. As a result, the computation mechanism under the capital gains provisions could not be applied and thus, the charging provisions also fail.

When a capital receipt is not chargeable to tax under the head 'capital gains', it cannot be taxed under any other head of income[10].

Tax withholding applicable only when income is chargeable to tax

Given that the compensation received by the taxpayer did not constitute taxable income, the Court held that withholding provisions were not applicable[11].

Accordingly, the High Court quashed the order passed by the Revenue rejecting the application for the Nil withholding certificate.

Aligned with Delhi High Court ruling

Placing reliance on the decision in the case of Sanjay Baweja which involved identical transaction relating to another employee of I Ltd, the High Court noted that the said judgment had not been challenged by the Revenue and had attained finality, making it binding upon the Revenue.

---

9 *CIT* v. *B C Srinivas Shetty* [1981]128 ITR 294 (SC)

10 *CIT v. D.P. Sandu Bros. Chembur (P.) Ltd.* [2005] 142 Taxmann 713 (SC)

11 *Vijay Ship Breaking Corporation v. CIT* [2009] 314 ITR 309 (SC); *CIT v. Canara Bank [*2016] 386 ITR 229

Distinguished Madras High Court ruling

The High Court distinguished the single-judge decision of the Madras High Court in the case of *Nishithkumar Mukeshkumar Mehta*, *inter alia,* on the following grounds:

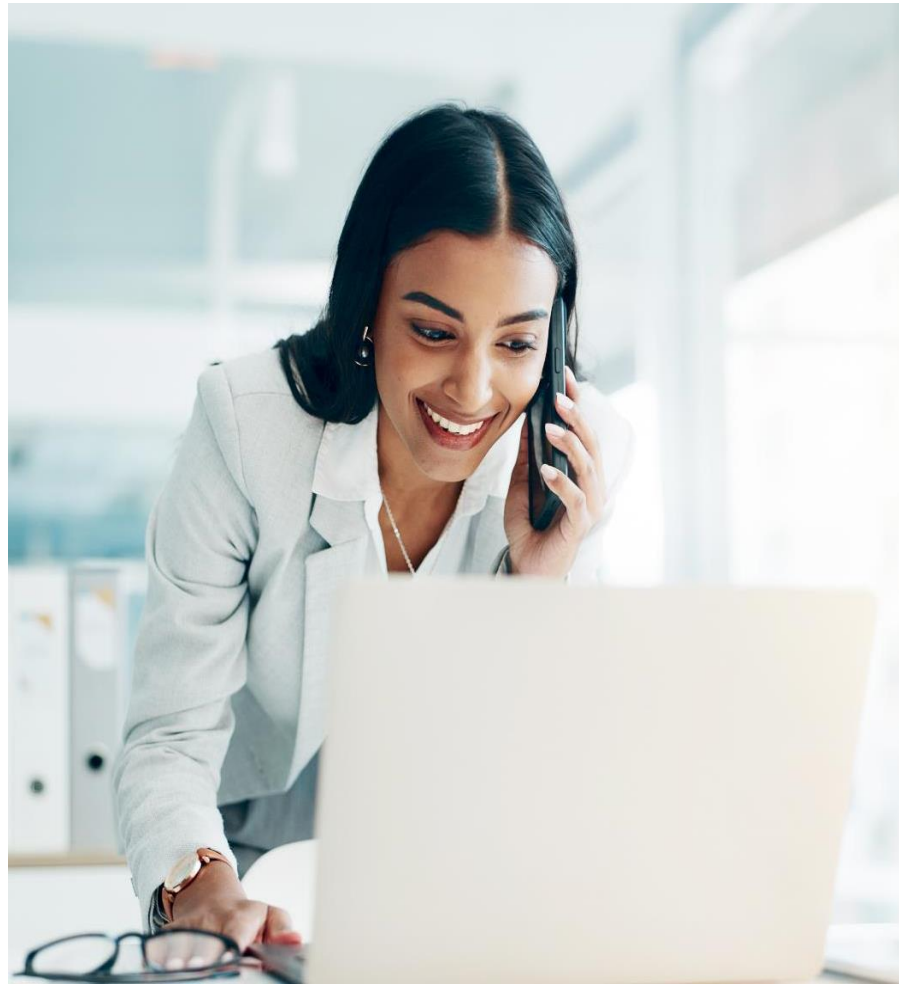
- The decision is under challenge and has not attained finality.
- The decision erroneously concludes that the compensation could be taxed as perquisite under the income head 'Salaries', as this issue was not contested by either party in that case.
- The Revenue had rejected the Nil withholding certificate application on the basis that compensation was taxable as capital gain as the petitioner had transferred the right to sue (which was a capital asset). The Single Judge categorically held that the impugned order was incorrect and the finding that the compensation was taxable as capital gains was incorrect. Having said so, the Judge should have allowed the writ petition and set aside the impugned order.
- The judgment incorrectly concluded that stock options are not capital assets as the definition of 'capital asset' under the Act[12] is very wide.
- It wrongly classified stock options as non-revenue generating.
- The ruling overlooked binding precedents from the Supreme Court and other High Courts, which were relied upon in *Sanjay Baweja* case, to hold that voluntary compensation for diminution in value of a profit-making structure constitutes a capital receipt not subject to tax.
- It failed to recognise that as the taxpayer in this case had not exercised stock options, perquisite provisions could not be invoked and in the absence of computation mechanism, no tax could be levied.
- The judgment disregarded the fact that stock options were allotted to employees of group companies, advisors, consultants, etc. A compensation to such diverse group could not be characterised as perquisites or salaries.

[12] Section 2(14)

Our comments

This judgment reaffirms that the character of a payment as capital or revenue needs to be evaluated from the recipient's perspective and after considering the relevant facts of each case. It also emphasises that a payment linked to stock options does not automatically qualify as a perquisite under the Act.

However, given the controversy surrounding the taxability of compensation received due to loss in value of stock options and differing views of the Courts, the matter is likely to remain litigious.



KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor, 902, Near Vodafone House, Corporate Road, Prahlad Nagar, Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Hyderabad
Salarpuria Knowledge City, Orwell 6th Floor, Unit-3, Survey No 83/1, Plot No 2, Raidurg, Hyderabad – 500 081.
Tel: +91 40 6111 6000

Noida
Unit No. 501, 5th Floor, Advant Navis Business Park, Tower-A, Plot# 7, Sector 142, Expressway Noida, Gautam Budh Nagar, Noida – 201 305.
Tel: +91 0120 386 8000

Bengaluru
Embassy Golf Links Business Park, Pebble Beach, 13/02, 'B' Block, 1st & 2nd Floor, Off Intermediate Ring Road, Bengaluru – 560 071
Tel: +91 80 6833 5000

Jaipur
Signature Towers, Office No. 402, Fourth Floor, S Plot No. DC-II, Lal Kothi District Shopping Center, Tonk Road, Jaipur – 302 001
Tel: +91 141 – 672 1000

Pune
9th floor, Business Plaza, Westin Hotel Campus, 36/3-B, Koregaon Park Annex, Mundhwa Road, Ghorpadi, Pune – 411 001.
Tel: +91 20 6747 7000

Chandigarh
Elante Offices, Unit No. A505, 5th Floor, Plot No.178-178A, Industrial Area Phase-1, Chandigarh – 160 002.
Tel: +91 172 664 4000

Kochi
Syama Business Centre, 49/179, 3rd Floor, NH 47, Bypass Road, Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Chennai
KRM Towers, Ground, 1st, 2nd, & 3rd Floor, No. 1, Harrington Road, Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Kolkata
Unit No. 604, 6th Floor, Tower – 1, Godrej Waterside, Sector – V, Salt Lake, Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
Lodha Excellus, Apollo Mills Compound, 2nd Floor, N M Joshi Marg, Lower Parel, Mumbai- 400 011.
Tel: +91 22 3989 6000

Vadodara
Ocean Building, 303, 3rd Floor, Beside Center Square Mall, Opp. Vadodara Central Mall, Dr. Vikram Sarabhai Marg, Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
PR heights, 4th Floor, NH 16 Service Rd, opp. Manipal Hospital Road, Tadepalle, Andhra Pradesh – 522 501.
Tel: +91 0864 536 2000

Gurugram
Building No.10, 8th Floor, DLF Cyber City, Phase II, Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

kpmg.com/in
Follow us on:
kpmg.com/in/socialmedia

KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Lower Parel, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000