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ESOP: A wealth creation and retention tool - Whether discount on ESOP is an allowable deduction

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Introduction

While defining the importance of ESOP for corporates, Russell B. Long, an American Senator had once said that

> "Bring on those tired, labor-plagued, competition-weary companies and ESOP will breathe new life into them. They will find ESOP better than Geritol. It will revitalize what is wrong with capitalism. It will increase productivity. It will improve labor relations."

ESOP is a wealth creation process for employees where employers reward employees by making them partners/rightful owners in wealth which they have built together. It is used as a retention tool and providing incentives to the employees as a part of their remuneration in order to compensate them for the continuity of their services to the company. The nature of expenditure clearly justifies that it should be an allowable expenditure. However, Hon'ble Supreme Court has held in the case of *DR. T.A. Quereshi*[1] v. *CIT* that

> ".... cases are to be decided by Court on legal principles and not on one's own moral views. Law is different from morality, as the positivist jurists Bentham and Austin pointed out."

It is a matter of litigation from a long time that the discount under ESOP should be considered as an allowable expenditure or not. Recently, in the landmark judgment of Biocon Ltd[2], the Karnataka High Court has given a detailed reasoned judgement which clarifies many issues related to its allowability under section 37(1) of the Income-tax Act, 1961 ('the Act') as business expenditure, about its nature, period of its allowability and quantification etc.

This study discusses the basics of ESOP scheme amid the principles laid down by hon'ble High Courts and ITATs. It also tries to find out that whether the Biocon ruling has been able to conclude the matter or still there is a long path to go.

Employee Stock Option/Ownership Plan ('ESOP')

Section 2(37) of Companies Act, 2013 defines "employees stock option" which means, 'the option given to the directors, officers or employees of the company or of its holding company or subsidiary company or

companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.'

An ESOP is a right to buy shares at a pre-determined price. In an ESOP, a company undertakes to issue shares to its employees at a future date at a price lower than the current market price. The employees are given stock options at discount and the same amount of discount represents the difference between market price of shares at the time of grant of option and the offer price. In order to be eligible for acquiring shares under the scheme, the employees are under an obligation to render their services to the company during the vesting period as provided in the scheme. On completion of the vesting period in the service of the company, the option vest with the employees.

Attracting and retaining competent personnel/employees is an uphill task faced by all organizations. Besides cash rewards, it is important for an organization to make its employees believe that their personal growth is linked with the growth of the organization. ESOP is one of the important tools to achieve this objective.

Allowability of discount on ESOP to Employers

There is no specific section under which ESOP expenditure is allowable under the Act. The only provision where a company can claim the expenditure is section 37(1) of the Act, which is a residuary section, hence, it is pertinent to test the conditions mentioned in section 37(1) in order to conclude whether the expenditure is allowable or not.

A. Allowability under section 37(1) of the Act

Section 37(1) of the Act allows an assessee to claim expenditure if it fulfills the following conditions:

(1) It should be an expenditure,
(2) It should not be dealt in section 30 to 36,
(3) It should not be a capital expenditure or personal expense of the assessee, and
(4) It should be incurred or laid out wholly and exclusively for the purpose of business or profession.

(I) Whether Discount on ESOP is an expenditure

Nature of Discount on ESOP *i.e.* business expenditure/loss v. capital/revenue expenditure

"Section 37(1) covers cases of business expenditure only, and not of business losses which are, however, deductible on ordinary principles of commercial accounting. It has also been held that in the circumstances of a case, 'expenditure' may cover an amount of loss which has not gone out of the assessee's pocket, *e.g.* discount at which bonds or debenture are issued.[3] ". **(According to the Law and Practice of Income-tax by Kanga and Palkhivala, page no. 1100 of the eleventh edition)**

In the case of ***Woodword Governor***[4], the SC has held that, it is this principle which attracts the provisions of section 145. That section recognizes the rights of a trader to adopt either the cash system or the mercantile system of accounting. The quantum of allowances permitted to be deducted under diverse heads under sections 30 to 43C from the income, profits and gains of a business would differ according to the system adopted. This is made clear by defining the word "paid" in section 43(2), which is used in several sections 30 to 43C, as meaning actually paid or incurred according to the method of accounting upon the basis on which profits or gains are computed under section 28/29. That is why in deciding the question as to whether the word "expenditure" in section 37(1) includes the word "loss", one must read section 37(1) with section 28, section 29 and section 145(1).

Whereas, the **Delhi ITAT in the case of *Ranbaxy Laboratories***[5] has held that the ESOP expense debited to P&L is notional in nature since the assessee has neither laid out or expended any amount while choosing to receive no/lesser securities premium. The alternative argument that this ITAT has supported is since the receipt of securities premium is not chargeable to tax being a capital receipt any short collection of security premium should also be considered as capital outlay and cannot be allowed as expenditure.

In the case of ***Dr. T.A. Quereshi referred supra***, the Apex Court has differentiated business loss from business expenditure u/s 37(1) **but it has also been held that business losses are allowable on ordinary commercial principals in computing profits**.

Recently, the **Karnataka High Court in the case of *Biocon Ltd.***as referred *supra* has held that the expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount where the assessee absorbs the difference between the price at which it is issued and the market value of the shares, would also be expenditure incurred for the purposes of section 37(1) of the Act. The primary object of the aforesaid exercise is 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 Madras High Court in ***PVP Ventures Ltd.***[6] and Delhi High Court in the case of ***Lemon Tree Hotel Ltd.***[7] have also upheld the claim of such deduction.

Discount on ESOP is contingent liability or ascertained liability

A contingent liability is not 'expenditure', and therefore, cannot be the subject of deduction even under the mercantile system of accounting. (According to the Law and Practice of Income-tax by Kanga and Palkhivala, page no. 1100 of the eleventh edition) However, where the provision or liability is scientifically and accurately determined and made reasonably for ascertained liability, it is deductible. In the case of ***Calcutta Co Ltd.***[8], the Apex Court has held that if a liability has been definitely incurred in the accounting year, *e.g.* an unconditional contractual liability, it cannot be regarded as contingent liability merely because it is to be discharged at a future date and the cost of discharging it is not definite but has to be estimated. Similarly, the Supreme Court, in the case of ***Bharat Earth Movers***[9], has allowed the provision for a liability for encashment of earned leave by workers.

The House of Lords laid down in *Owen* v. *Southern Rly* [10], that a deduction should be allowed in respect of the liability to pay retiring benefits or deferred remuneration in the future, provided the liability is accurately estimated, *e.g.* upon an actuarial valuation.

After going through, the above-mentioned case laws, following principles emerges which is directly applicable to the Scheme of ESOP, *i.e.*

(a) Section 37(1) **does not contain a requirement that there has to be a payout.** If an expenditure has been incurred, provisions of section 37(1) of the Act would be attracted. It **does not envisage incurrence of expenditure in cash.** It depends upon the method of accounting upon the basis on which profits or gains are computed under section 28/29 as mentioned u/s 145.
In ESOP, issuance of shares at grant price (at discount or at Nil price), where the company absorbs the difference between the grant price and the market value of the shares, would be an expenditure which has been incurred even though there is no payout by the company, hence it is an allowable expenditure.

(b) Once a liability is incurred, it would be a deductible expense notwithstanding that the quantification itself is deferred to a future point of time. **It cannot be considered as contingent liability once it is ascertained even though not exactly quantified.**
In ESOP Scheme, the incurring of liability is certain as there will be definite vesting of a few options

if not all over the vesting period and only the exact quantification is not possible at the stage of grant of options. It can be concluded that discount under ESOP is not a contingent liability.

(c) The deduction of discount on ESOP over the vesting period is in accordance with the accounting in the books of account, which are prepared in accordance with **SEBI Guidelines**[11] and **Regulations**[12]. Regulation 15 of the Guidelines mandates a company which is implementing any of the share based schemes to follow the requirements of the 'Guidance note on the accounting for employee share based payment' or accounting standards as prescribe by the ICAI from time to time. A similar provision is present in the SEBI (Share Based Employee Benefits) Regulations, 2014. As per Indian Accounting Standard 102 "Share-based Payments", the cost *i.e.* the difference between the fair market value of the shares as on the date of the grant less the grant price is distributed over the vesting period.

Although, Accounting Standards and principles do not per se determine the taxability or otherwise of a receipt or payment, the accounting principles can be taken note of where such principles are not contrary to the principles of taxation.

(II) ESOP expenditure is laid out wholly and exclusively for the purpose of business or profession.

ESOPs are being increasingly used as a compensation tool to attract and retain talented employees. Companies believe that ESOPs enhance productivity, motivate employees and increase employees' interest in the company's overall performance. With the market bouncing back, job opportunities are being created at large. Hence, in the interest of company such type of incentive required and accordingly SEBI also approved such mechanism.

Companies are looking at competent employees who can stay with them for a longer period. This means giving them something more than just cash reward, thus, organizations are coming up with an ESOP scheme for their employees. In this cut -throat competitive business environment, ESOPs are one of the important tools to attract and retain employees. The feeling of ownership encourages employees to have long term career aspirations in the organization. It aligns employees' aspirations with the long-term objectives of the organization. Therefore, in such situations, there is exerting obligation on part of the employers to retain its competent & qualified work force. Based on the above, it can be concluded that ESOP expenditure is made wholly and exclusive for the purpose of business or profession.

(III) Discount on ESOP is not an admissible expenditure under section 30 to section 36 and it falls under the residual provision which is section 37(1) as discussed in the first paragraph.

(IV) ESOP is not a capital expenditure but a revenue expenditure which should be distributed over the vesting period as per the Indian Accounting Standard 102 on "Share-based payments". The **Special Bench of ITAT in the case of *Biocon Ltd.***[13] has held that

> ".....Reverting to the questions of 'when' and 'how much' of deduction for discount on options is to be granted, we hold that **the liability to pay the discounted premium is incurred during the vesting period and the amount of such deduction is to be found out as per the terms of the ESOP scheme by considering the period and percentage of vesting during such period.** We, therefore, agree with the conclusion drawn by the tribunal in *S.S.I. Ltd.'s* case[14] allowing deduction of the discounted premium during the years of vesting on a straight-line basis, which coincides with our above reasoning." (emphasis applied)

B. Additional Arguments/issues

(I) Discount on premium under ESOP is a benefit provided by employer to its employees

There is another important dimension of this issue which has been discussed in the case of Biocon Ltd by the Special Bench of ITAT, Bangalore (*supra*). Chapter XII-H of the Act consisting of sections115W to 115WL with the caption: "Income-Tax on Fringe Benefits" had been inserted by the Finance Act,2005 w.e.f. 1-4-2006. Memorandum explaining the provisions of the Finance Bill, 2005 highlights the details of the Fringe Benefits Tax. It provides that:

> 'Fringe benefits as outlined in section 115WB, mean any privilege, service, facility or amenity directly or indirectly provided by an employer to his employees (including former employees) by reason of their employment. Further, it also provides that **'fringe benefits' includes any specified security or sweat equity shares allotted or transferred**, directly or indirectly, by the employer free of cost or at concessional rate to his employees (including former employee or employees)'. (emphasis applied)

Thus, it is discernible from the above provisions of the Act that **the legislature itself contemplates the discount on premium under ESOP as a benefit provided by the employer to its employees during service.** If the legislature considers such discounted premium to the employees as a fringe benefit or 'any consideration for employment', it is not opened to argue contrary. Once it is held as a consideration for employment, the natural corollary which follows is that such discount is an expenditure and is an allowable deduction.

(II) Double taxation in case the ESOP expenditure is not allowable

The action of the department in denying the allowability of the claim of ESOP Cost shall result into double taxation of the same item as under:

(a) Disallowance of discount on ESOP as an expenditure
(b) Difference of FMV and grant price is chargeable as perquisite in hands of employees

Currently, ESOP benefits are taxable as perquisite and form part of employee's salary income. The employer is required to withhold tax at source in respect of such perquisite. **(Section 17(2)(*vi*) of the Act - as inserted by Finance (No. 2) Act, 2009)**. The perquisite value is computed as the difference between the FMV of the share on the date of exercise and the exercise price. There are specific valuation rules prescribed for listed and unlisted companies. Unlisted companies need to determine the FMV by a Category I Merchant Banker registered with SEBI.

According to unambiguous provisions of section 17(2) of the Act, said item is taxable in the hands of employees as Perquisite, therefore, now there is no reason to again make double taxation in hands of employer of same item.

The Scottish doctrine of **'approbation and reprobation'** provides that a person cannot both assert his rights acquired from part of a document and reject the rest of the document at the same time. Denial of the claim of ESOP expenses debited to profit and loss statement shall result into clear cut breach of this tenet of law. It is abundantly clear from law as on date that the amount of ESOP Expenses is taxable to employees as perquisite. Then it is incumbent on the department to consider the claim of the ESOP cost judicially.

(III) Subsequent adjustment to discount after the grant of share options under ESOP

As discussed in above paragraph, the amount of ESOP expenses should be equal to the amount which is taxable as perquisite. However, in two situations it can be different from the same which are quite practical *i.e.*

(a) When the options remain unvested or lapse at the end of exercise period

When the options remain unvested or lapse at the end of the exercise period, there is no employee cost to that extent and hence there can be no deduction of discount *qua* such part of unvested or

lapsing options. But, as the amount was claimed as deduction by the company during the period starting with the date of grant till the happening of this event, such discount needs to be reversed and taken as income.

SEBI Guidelines also provide that the discount written off in respect of unvested options and the options lapsing at the end of the exercise period shall be reversed at the appropriate time. As the accounting treatment directed through the Guidelines accords with the taxation principle of not allowing deduction of discount on unvested/lapsing options.

(b) Due to difference between the FMV at the time of grant of options and the FMV at the time of exercise of options. ("true up adjustment")

The amount of discount at the stage of granting of options w.r.t. the market price of shares at the time of grant of options is always a tentative employees cost because of the impossibility in correctly visualizing the likely market price of shares at the time of exercise of option by the employees, which, in turn, would reflect the correct employees cost. It is this market price at the time of the grant of options which is considered for working out the amount of discount during the vesting period. But, since actual amount of employees 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. It can be done by making suitable northwards or southwards adjustment at the time of exercise of option.

While analysing the above principle in the case of Biocon Limited, the SB of Bangalore ITAT also referred the Supreme Court rulings in the case of Tuticorin ***Alkali Chemicals & Fertilizers Ltd.***[15] and ***Godhra Electricity Co. Ltd.***[16] where it follows that accounting principles have absolutely no role to play in the matter of determination of total income under the Act. If an accounting principle is referred to by the higher judiciary, then there is an underlying presumption that such accounting principle is in conformity with and not in conflict with the taxation principle. The essence of the matter is that taxation principles are to be followed. If an accounting principle is in conformity with the mandate of taxing principle and reference is made to such accounting principle while deciding the issue, it does not mean that the accounting principle has been followed. It simply means that the taxation principle has been followed and the accounting principle, which is in line with such taxation principle, has been simply taken note of. If, however, an accounting principle runs counter to the taxation principle, then there is no prize for guessing that it is only the taxation principle which shall prevail.

However, it is significant to note that, in the Karnataka HC ruling in case of *Biocon Ltd*. did not adjudicate upon the allowability of "true up adjustment". Hence, the issue of allowability of "true up adjustment" remains to be tested by HCs and the SC.

Conclusion

In the light of the above discussion, it can be precisely concluded that ESOP costs debited by the Employers in the statement of Profit and Loss is not at all notional loss or contingent liability, on the contrary same is a business expenditure incurred wholly and exclusively for the purpose of the business and same deserves allowability under the Income-tax Act while computing 'Profits and gains of business or profession.

It seems that the recent judgment of Karnataka High Court has cleared the clouds on the variety of decisions given by various tribunals and high courts and has settled the dust. However, the revenue authorities are still disallowing the ESOP expenditure at assessment level being revenue is still in appeal before the higher forums. Till, a decision is not passed at the level of supreme court or a clarification is not issued by the CBDT in respect of allowability of discount of premium under ESOP, it will continue to be a controversial issue.

(The views, thoughts, and opinions expressed in the text belong solely to the author, and not necessarily to the author's employer, organization, committee or other group or individual)

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1. *Dr. T.A. Quereshi* v. *CIT* [2006] 287 ITR 547/287 ITR 547
2. *CIT* v *Biocon Ltd.* [2020] 121 taxmann.com 351 (Kar.)
3. *Madras Industrial Investment Corp.* v. *CIT* [1997] 225 ITR 802/91 Taxman 340 (SC)
4. *CIT* v. *Woodword Governor India (P.) Ltd* [2009] 179 Taxman 326/312 ITR 254 (SC)
5. *ACIT* v. *Ranbaxy Laboratories* [IT Appeal No 2613 & 3871 (Delhi ITAT)]
6. *CIT* v. *PVP Ventures Ltd.* [2012] 23 taxmann.com 286/211 Taxman 554 (Mad.)
7. *CIT* v. *Lemon Tree Hotels Ltd.* [IT Appeal No. 107 of 2015, dated 18-8-2015] (Delhi)
8. *Calcutta Co Ltd.* v. *CIT* [1959] 37 ITR 1 (SC)
9. *Bharat Earth Movers* v. *CIT* [2000] 245 ITR 428/112 Taxman 61 (SC)
10. *Owen* v *Southern Rly of Peru Ltd*,[1956] 36 TC 602 (HL)
11. Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999
12. Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014
13. *Biocon Ltd.* v. *Dy. CIT* (LTU) [2013] 35 taxmann.com 335/[2014] 144 ITD 21 (Bang.- Trib.) (SB)
14. *S.S.I. Ltd.* v. *Dy. CIT* [2004] 85 TTJ 1049 (Chennai)
15. *Tuticorin Alkali Chemicals & Fertilizers Ltd.* v. *CIT* [1997] 227 ITR 172/93 Taxman 502 (SC)
16. *Godhra Electricity Co. Ltd.* v. *CIT* [1997] 225 ITR 746/91 Taxman 351 (SC).