

Tax deductibility of ESOP costs - Recent judgement of far reaching implications

One of the thorny issue discouraging companies from issuing ESOPs was the Accounting charge and its non-deductibility for tax computations. A judgement from the special bench of ITAT, Bengaluru in 2013 in the case of Biocon Ltd. had decided in favour of the company and allowed its claim for the tax computation. The judgement not only allowed the deduction for the accounting charge but went a step ahead and allowed the company to claim the Perquisite value (on which employees paid Perquisite tax at the time of exercise) as a deduction.

This judgement somehow was not taken seriously by the Assessing officers as well as the companies. The Assessing officers in other jurisdictions disallowed the claims since they felt the matter was sub-judice and the Companies thought claiming anything more than the Accounting charge would be too ambitious.

Recent judgement of the Mumbai bench of ITAT (in the case of Kotak Mahindra Bank), re-in forced the thinking of the Bengaluru bench and reprimanded the Department for incorrectly presuming that the matter was sub-judice. The Mumbai Bench squarely applied the ratio laid down in the case of Biocon Limited and clarified that unless the jurisdictional High Court stays or sets aside or any other High Court takes a contrary view, the principles laid down by Special Bench in Biocon's case shall prevail.

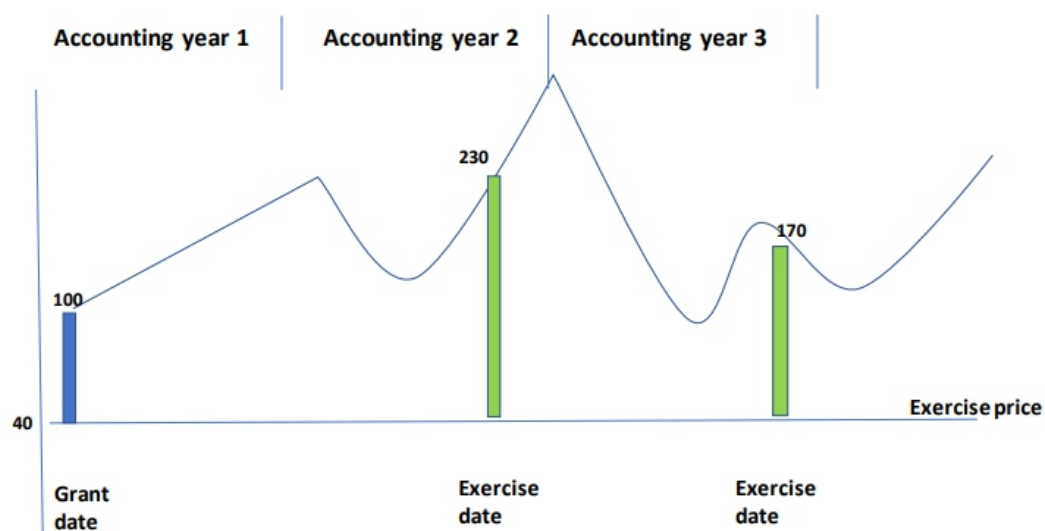
What do both these judgements re-inforce?

The Tax authorities have come around to the view that if the employee has been offering to tax his gains from ESOPs as a perquisite, the Company (his employer) should get the same as its deductible expense.

The judgement in case of Biocon (and quoted in the judgement of Kotak Mahindra bank) clearly lays down that "It is palpable that since the remuneration to the employees under the ESOP is the amount of discount w.r.t. the market price of shares at the time of exercise of option, the employees cost in the hands of the company should also be w.r.t. the same base."

In short, it is now clear that unless the claim is set aside by High Court or other higher judicial authority, Tax authorities would allow the employer companies to claim the "Perquisite value" as a deductible expense in the year in which the employee pays tax on such "Perquisite value".

The impact of the judgement can be understood better with the help of an example:



Granted	100			
Vested		50		50
Exercised			30	70
Accounting charge (IGAAP) (100*(100-40)= 6,000)	4,500 (75% of 6000)	1,500 (25% of 6,000)		Total Accounting charge 6,000
Eligible Tax claim (capped to Perquisite value)		5,700 (30*(230-40))	9,100 (70*(170-40))	Total Taxable deduction 14,800

The method of calculating the permissible claim was different in both the cases, however the total deduction over the Plan period - which is equal to the Perquisite value and capped at that level – is the same in both the cases.

Far reaching implications

These judgements have far reaching implications with respect to attractiveness of ESOPs for companies and acceptability by the Revenue of ESOP costs as employee remuneration.

- **Matching Income and expense**

While ESOP gains have always been taxed as Income in the hands of the employee, it is only now that it is also accepted as a permissible expense in the hands of the employer company.

- **Direct co relation between value creation and permissible expense**

By allowing companies to claim deduction of the Perquisite value, the Revenue has de-linked the relation between what is charged in the books (Accounting charge) and permissible expense. The companies can now claim higher deduction if they create more value for the employees. In other words it is a win-win for both the employee as well as employer when it comes to value creation.

- **Permissible expense could be higher than the Accounting charge**

Since what is permissible is a function of the “Value” created and not of what is charged as cost, it is likely that in some cases companies will be able to claim a higher deduction than what they charge in books.

- **Higher deduction may also lead to taxable losses**

With the evolving business and valuation models, it is likely that business valuations (and hence Perquisite value) will grow even though the company is making losses or lower profits. In such a case, company could have taxable losses because of higher permissible expense. For instance, employees of several e-commerce companies pay perquisite tax as the business valuations are growing, however they have very low taxable profits or even losses. In such cases, claiming high Perquisite value as permissible expense could result into taxable losses which can be carried forward for eight years.

- **Claims will be higher in case of Discounted Options / RSUs**

Since there would be direct co relation between the Perquisite value and permissible expense, instruments such as RSUs, will become more attractive for companies. Apart from lower dilution, such instruments will also mean higher tax deduction and zero downside risk for employees.

- **Perquisite in the form of ESOPs will be preferred over other cash perquisites**

While ESOP perquisites will have same tax treatment as any other perquisite, companies will prefer the former because it is not a cash payout. For example, a perquisite such as LTA, will be permissible to the extent of paid by the company, perquisite from ESOPs are paid by the market but claimed by the company. This will be a big plus for the companies to use ESOPs to incentivise and remunerate employees.

Case for formalising the tax position


All said and done, both the decisions referred above are ITAT decisions and by no means can be claimed as law. However, there is a strong case for the Government to make it into a formal legal provision.

By allowing Perquisite value as a deductible expense for companies, the Government is foregoing corporate tax on the said value. On an average effective Corporate tax is in the range of 20-22%. As against this, the same Perquisite is taxed at 33% in the hands of the employee (most of the Option holders fall in this bracket). By encouraging more and more companies to grant ESOPs, the Government will earn more than 10-12% on every Rupee of Perquisite generated by such Plans.

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