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Can Esop income be taxed as capital gains?

Esops may at times be taxable as capital gains, where Esops are not exercised but transferred

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Gautam Nayak

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A couple of recent interesting tribunal decisions have now thrown up some new aspects of taxation of Esops. Photo: iStock

For the past few years, one thought that there is now clarity in the tax law regarding the taxation of employees stock options (Esops). Esops are first granted or allotted by the employer, then vest over a certain period (which makes the employee eligible to apply for shares by exercising Esops), then the employee exercises the option to apply for shares by

paying the exercise price, and finally the shares are allotted by the company. The law provides that the benefit arising due to Esop is taxable as a perquisite in the year of exercise of Esop, and the difference between the fair market value of the shares on the date of exercise and the exercise price is the taxable value. A couple of recent interesting tribunal decisions have now thrown up some new aspects of **taxation of Esops**.

In a recent case before the Bangalore Tribunal, an employee had been granted Esops at different points of time by his employer's holding company. These had not been exercised by the employee, though Esops had vested. The holding company entered into an option transfer agreement with the employee, transferring Esops held by the employee to the holding company.

The employee treated the gains arising on transfer of Esops as capital gains, with gains on Esops granted more than three years before being treated as long term. Since the employee had invested in capital gains bonds, he claimed exemption for **long-term capital gains (LTCG)**.

The tax officer treated the gains as short-term capital gains (STCG), treating Esops as having been exercised on the date of transfer of the options and, therefore, denied the exemption for investment in capital gains bonds. In appeal, the commissioner (appeals), the first appellate authority, confirmed the treatment of the entire capital gains as STCG, taking a view that the date of acquisition of Esops was the date of vesting, and not the date of grant.

The tribunal noted that this was not a case of exercise of Esops, followed by transfer of the allotted shares, but was a case of transfer of Esops without exercise of the options. It noted that Esops were valuable rights to exercise and receive allotment of shares. According to the tribunal, the employee held these rights from the date of grant, and not from the date of vesting. The tribunal, therefore, confirmed the treatment of capital gains on Esops granted more than three years before the transfer of Esops as LTCG.

The interesting aspect that this case confirms is that in a situation where Esops are not exercised at all, but are transferred, the gains are not taxable as a perquisite in the hands of the employee, but as capital gains. Further, the long-term or short-term nature of the capital gains is to be gauged with reference to the date of grant of Esops, and not the date of vesting of Esops.

The other interesting tribunal decision was a case where the promoter of a company left the employment of the company, and exercised his outstanding Esops, which would have otherwise lapsed on cessation. There were certain conditions laid down in the separation agreement, and the shares were allotted only on compliance with these conditions, after

six months from the date on which the options were exercised. Tax was deducted at source by the company on the value of Esop perquisite only on the date of allotment of the shares.

According to the tax authorities, the tax on Esop perquisite ought to have been deducted by the company when the promoter exercised the options, and not when the shares were actually allotted to him.

The tribunal observed that mere exercise of Esops was not sufficient, but certain essential conditions linked to Esops also had to be complied with, for the benefit to accrue to the promoter. It was only when those conditions were complied with, that the shares were allotted, and the benefit was received by the promoter. According to the tribunal, the withholding tax obligation was triggered only on the date of allotment of the shares by the company, and not on the date of exercise of Esops.

Therefore, from these decisions, it is clear that the taxation of the value of Esops is not necessarily always as a perquisite, but may at times be taxable as capital gains, where Esops are not exercised but are transferred. Further, the point of **taxation of Esops** is not the date of exercise of the option under Esops, but the actual date of allotment of the shares pursuant to such exercise of Esops.

Gautam Nayak is a chartered accountant

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