ESOP expenditure incurred pursuant to a Business Transfer Agreement is deductible while computing gain for a transfer by way of slump sale

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In brief

In a recent decision, the Delhi High Court (HC), held that in case of a slump sale, the amount paid by the taxpayer to purchase shares from its employees through the Employee Stock Option Plan (ESOP) Trust was non recoverable and a contractual liability of the taxpayer. Hence, the amount paid was wholly and exclusively for the purpose of effecting the transfer and should be allowed as an expense while claiming capital gains.

In detail

Facts

- The taxpayer[1] sold its trading division on slump sale basis as a going concern to E Limited through a Business Transfer Agreement (BTA).
- As part of the BTA, E Limited took over the management and employees of the taxpayer. However, E Limited expressed its inclination to discontinue the ESOP Trust.
- As a condition precedent to the BTA, the employees of the taxpayer would become employees of E Limited on the same terms and conditions, except that benefit of the ESOP would not be available to the employees of E Limited.
- To protect the interest of the employees, the ESOP Trust entered into an agreement with the employees for purchase of shares allotted to them at a pre-determined price.
- Accordingly, for the ESOP Trust to purchase the shares from the employees, the taxpayer had to fund the money to the ESOP Trust.
- The taxpayer claimed deduction of the amount funded to the ESOP Trust while computing capital gains in respect of the slump sale.
- The Revenue opined that this expenditure was not integrally connected with the transfer and was therefore not adjustable from the computation of capital gains.

Issue before the High Court

Revenue filed an appeal before the HC on the following issue:

- Whether the amount paid by the taxpayer to the ESOP Trust for purchase of shares could be deductible from the computation of capital gain in respect of slump sale of trading business

[1] [2016] 75 taxmann.com 282 (Delhi)

under section 48 of the Income-tax Act, 1961 (the Act)?

Key contentions of the taxpayer

- The amount funded to the ESOP Trust to purchase the shares from the employees was in pursuance to the BTA, which was a contractual liability of the taxpayer.
- The money funded to the ESOP Trust was not recoverable from the ESOP Trust.
- Further, without the purchase of shares by the ESOP Trust from the employees, the transfer of the trading division would not have been possible as it was a condition precedent to the BTA.
- Hence, the amount funded to the ESOP Trust had been incurred wholly and exclusively in connection with the transfer of the trading division on slump sale basis as provided in section 48 of the Act.

Key contentions of the Revenue

- The amount funded to the ESOP Trust was not integrally connected with the transfer of trading undertaking and therefore not adjustable in computing the capital gain.

High Court's ruling

- The HC held that in order to give effect to the BTA, it became imperative for the taxpayer to fund the ESOP Trust as it was a pre-requisite for the consummation of the transaction.
- As a result, the funding of the ESOP Trust became an integral part of the transfer itself.
- Further, the amount was non-recoverable and was a loss on the account of business transfer.
- In these circumstances, the mode of computation of capital gains had to necessarily take into consideration the ESOP funding by the taxpayer at the stage of transfer.

The takeaways

- It is pertinent to note that section 48 of the Act provides that expenditure incurred wholly and exclusively in connection with transfer of capital asset be allowed as deduction from the full value of consideration.
- Thus, in respect of expenditure incurred by a seller for meeting any contractual liability that was a pre-requisite to the transfer of an asset could be termed as expenditure incurred wholly and exclusively in connection with transfer of capital asset, and should be allowed as deduction while computing capital gains.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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