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ESOP cost accounted in books as per SEBI guidelines held to be staff welfare expenditure and eligible for deduction

PVP Ventures Ltd.

In Brief

The Madras High Court, in a recent ruling[1], has upheld the proposition that the employees stock option plan (ESOP) cost under ESOP scheme charged to the profit and loss (P&L) account in accordance with accounting policies prescribed by the Securities Exchange Board of India (SEBI) guidelines is not a notional or contingent liability.

Facts

- The assessee is engaged in the business of computer training and software development.
- During assessment year (AY) 2000-01, the assessee had charged the ESOP cost to the profit and loss account under the head staff welfare expenditure.
- The ESOP cost was determined as the difference between the market value of shares and the value at which they were allotted to the employee as per the accounting policies prescribed in the SEBI guidelines.

[1] CIT *v*. PVP Ventures Ltd [TS-514-HC-2012(Mad)]

Issue

- Based on the above facts, the issue for consideration was whether the ESOP cost is allowable as business expenditure.

Revenue's contentions

- This is a case of enhancement done by the Commissioner of Income-tax (CIT) under section 263 of the Income-tax Act, 1961 (the Act) observing that though as per SEBI Guidelines, the ESOP cost is to be charged to the profit and loss account, it nowhere suggests that it is revenue expenditure eligible for deduction under income-tax. Thus, the CIT treated this cost as a notional and contingent expenditure.
- Accordingly, the ESOP cost charged to the profit and loss account as staff welfare expenditure should not be allowed as business expenditure.

High Court ruling

The High Court relied and upheld the ruling of the Income-tax Appellate Tribunal (the Tribunal), on the following lines:

- The ESOP cost was charged to the P&L account as per applicable SEBI Guidelines. Further, the intention behind the issue of shares under ESOP was only for the interest of the business of the assessee to induce employees to work in the best interest of the assessee. Once the ESOP option was given and exercised by the employee, the liability in this behalf got ascertained.
- Hence, ESOP cost charged to the P&L account as per prescribed SEBI guidelines was not a notional or contingent liability but an ascertained liability,
- On the above basis, it was held that the order of the assessing officer (AO) allowing such ESOP cost as a deduction while computing the business income cannot be considered to be erroneous so as to invoke the CIT's jurisdiction under section 263 of the Act.

Spray Engineering Devices Ltd

In brief

In a related development, the Chandigarh Tribunal in a recent ruling[2] held that amount debited to the P&L account by the assessee on the issue of sweat equity shares to the employees at a predetermined price, for consideration other than cash, as per provisions of section 79A of the Companies Act, 1956 (the Companies Act), is an ascertained liability and thereby allowable as an expenditure.

Facts

- The assessee is engaged in the business of manufacture and supply of machinery and items relating to the sugar industry.
- During financial year (FY) 2005-06, the assessee issued 394,692 equity shares at a predetermined price of INR.106.26 per share, for consideration other than cash, to its employees as a reward for past services and providing knowhow for making available rights in the intellectual property rights (IPR) to the assessee as sweat equity shares as per section 79A of the Companies Act. In this context, the total cost to the assessee amounting to INR 419 million was charged to P&L account as employees benefit expenses.
- The predetermined price of INR 106.26 per share was determined based on subscription agreement.

[2] CIT *v*. Spray Engineering Device Ltd. [TS-516-ITAT-2012(Chand)]

- The sweat equity were subject to a lock-in period of five years. i.e. in case the employee terminates employment before five years, the allotment of such shares was to be forfeited.

- The necessary resolutions for the issue of sweat equity shares were passed in the extra-ordinary general meeting (EGM) held on 31 March 2006. However, pending allotment formalities, in the financial statements for FY 2005-06, these shares were disclosed under 'shares outstanding account'. The shares were yet to be issued to the identified employees at the financial year end.

Issues

Based on these facts, the issue for consideration was whether the employee benefit expense debited to the P&L account is an ascertained liability or a contingent liability.

Revenue's contentions

- The AO observed that no allotment of shares was done as on the last day of the year under consideration (FY 2005-06).

- Further, the issue of equity shares was subject to a lock-in period wherein, if the employee terminates employment before the expiry of the lock-in period, his/her shares were to be forfeited by the management. During the lock-in period, the employee was not free to encash these shares.

- In light of the above, the AO disallowed the employee benefit expenditure charged to the P&L account on the premise that it was not an ascertained liability but a contingent liability. It was not benefit conferred on employees without restrictions.

- According to the AO, the liability of the assessee (in relation to issue of sweat equity) would be determined when the employee gives his/her option and is able to encash it without any restriction, which is not so in the year under consideration.

- The department representative (DR) during the course of hearing, had relied on the decision of the Delhi Bench of Tribunal in the case of Ranbaxy Laboratories Ltd.[3] and Mumbai Bench of Tribunal in the case of VIP Industries[4] wherein an identical issue was dealt with by the respective authorities. Similar expenditure claimed by the assessee was held as not eligible for deduction.

Assessee's contentions

- The employee benefit expense representing the price at which the sweat equity shares were issue was predetermined at INR106.26 per share, represents expenditure incurred for the benefit of employees and was to be allowed as deduction.

- The liability to issue the shares had crystallised on the last day of the year under consideration when it was approved by the special resolution in the EGM.

- Pending corporate compliance, the shares were not allotted to employees on 31 March 2006 but disclosed in 'shares outstanding account' under the head 'issued share capital'. The actual allotment was completed in May 2006, upon completion of all formalities.

- Hence, employee benefit expenditure charged to the P&L account represented a crystallised ascertained liability and not contingent liability.

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[3] Ranbaxy Laboratories Ltd. *v.* Addl .CIT [2009] 124 TTJ 771 (Del)
[4] VIP Industries *v.* DCIT [ITA No.7242/Mum/2008]

- The authorised representative relied on the principle laid down by the Chennai Tribunal in the case of SSI Ltd.[5] wherein identical expenditure was held to be eligible for deduction.

Tribunal ruling

- The Tribunal observed that the allotment of shares was not done on 31 March 2006. The facts of the case reflect that the assessee had specified the number of shares to be allotted to its employees as on 31 March 2006. Thereafter, the shares were so allotted. Accordingly, the Tribunal held that mere non-allotment of the shares pending completion of formalities does not merit the disallowance of employee expenditure as being a contingent liability.

- It further held that merely because under the scheme of allotment, there was a lock-in period of five years under which in case the employee left the employment before the expiry of five years, the shares so allotted to him/her would vest with the assessee company, does not make the liability as contingent in nature.

- It observed that the assessee had explained that as per the scheme, where the shares are forfeited by the management, the employee benefit expenditure claimed as deduction would be offered to tax in the relevant assessment year.

- The Tribunal distinguished the decisions of Ranbaxy Laboratories Ltd. and VIP Industries (above) relied on by the AO on the premise that the claim in those cases were for allowance of notional value of shares i.e. difference between the market price of the shares and the price at which shares were allotted to the employees under the ESOP scheme. Hence, they were at variance with the facts of the present case.

- In this case, the liability was clearly identifiable. Accordingly, the employee benefit expense debited to the P&L account was to be treated as an ascertained liability and not as a contingent liability. Hence, it was eligible for deduction in the year under consideration.

Conclusion

Interestingly, the Madras High Court in the ruling has held that the order of the AO allowing ESOP cost as a deduction while computing the business income cannot be considered to be erroneous for invoking the CIT's jurisdiction under section 263 of the Act. It is further observed that such expenditure is not a notional or a contingent liability.

In a separate development, Chandigarh Bench of Tribunal has dealt with specific facts before them of sweat equity issue at a predetermined price, for a consideration other than cash. In such a scenario, the Tribunal has held that such cost is an identified/ascertainable liability and not contingent in nature. Hence, the same is eligible for deduction. Applicability of the above would have to be evaluated in the context of ESOP cost, dealt in the cases of Ranbaxy Laboratories Ltd and VIP Industries (above).

[5] SSI Ltd. *v.* DCIT [2004] 85 TTJ 1049 (Chennai)

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Ahmedabad	Bangalore	Bhubaneswar	Chennai	Hyderabad
President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	PwC Center, 2nd Floor 32, Khader Nawaz Khan Road Nungambakkam Chennai 600 006 Phone +91-44 4228 5000	#8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata South City Pinnacle, 4th Floor, Plot – XI/1, Block EP, Sector V Salt Lake Electronic Complex Bidhan Nagar Kolkata 700 091 Phone +91-33 4404 6000 / 44048225	**Mumbai** PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com

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