Companies can get tax breaks on employee stock option plans

A special bench set up by the Bangalore Income-tax appellate tribunal (ITAT) has ruled that discounts under the employee stock option plans (ESOP) are an employee cost and should be allowed as a deduction, over the vesting period, in the hands of the issuing company.

The special bench held that when a company undertakes to issue ESOPs at a discounted price, the primary objective is not to raise share capital but to retain its key employees. It brushed off the contention of the tax authorities that such discount was a capital expenditure or that it was a contingent liability.

The special bench of the ITAT was set up to determine the deductibility of ESOP discount, as a clutch of companies including Biocon had filed appeals on this issue. The ITAT also had to determine when and how much should be allowed as a deduction.

The special bench held that when a company undertakes to issue ESOPs at a discounted price, the primary objective is not to raise share capital but to retain its key employees. "The objective is securing the consistent and concentrated efforts of its dedicated employees during the vesting period. The discount is construed, both by the employees and the company, as a part of the remuneration package. Such discounted premium on shares is a substitute to giving direct incentive in cash for availing of the services of the employees," stated the special bench in its order. It brushed off the contention of the tax authorities that such discount was a capital expenditure or that it was a contingent liability.

Punit Shah, co-head (tax), KPMG, says, "This decision offers substantial clarity. Going forward, more companies will be inclined to claim a deduction for the ESOP discount." Industry players feel it will result in a substantial decline in litigation.

The special bench of the ITAT was set up to determine the deductibility of ESOP discount, as a clutch of companies, including Biocon, had filed appeals on this issue. The ITAT also had to determine when and how much should be allowed as a deduction.

In a 50-page order relating to Biocon's case, the special bench looked into various stages of an ESOP scheme such as granting, vesting and exercise. At the grant stage, the company merely offers to make available shares at a discount price.

The second stage is vesting and the vesting period varies from company to company. During this period, the company incurs the obligation to issue discounted shares. The shares are allotted at the end of the vesting period, post which the employee can exercise his right to purchase the shares under the ESOP scheme at the discounted price.

(The Times of India)