Tax Review/Taxation

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This issue contains:

Kind Regards,

Huzaima Bukhari
Editor

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AA Consultants & Publishers

Suite # 14, 2nd Floor, Sadiq Plaza, Regal Chowk, Mall Road,
Lahore, Pakistan
Phone. 042-36365582 & 042-36280015 Fax 042-35310721
Email: sales@aacp.com.pk website: http://aacp.com.pk

VIEWPOINT: Tax evading MNAs and MPAs

by
Saida Fazal

A press report points out what we have always known: that our rich and powerful do not pay their dues to the State. Nearly half, ie, 47 percent, of the members of our ruling elites who entered the current assemblies in last May's elections paid zero tax on their incomes while 12 percent of them didn't bother even to acquire a National Tax Number. In several cases involving top leaders tax declarations made in nomination papers are contested by the FBR.

These tax evaders are almost evenly distributed among all the major parties proportionate to the number of their seats. Clearly, the issue has less to do with any one party's brand of politics and is more a product of an exploitative culture.

Barring a rare exception or two all MNAs and MPAs fall within the category of rich. Yet they refuse to pay their dues while governments beg the US for financial assistance. At one point, the former US secretary of state Hillary Clinton got so tired of getting requests for money that she used a public forum discussion in Washington to offer this advice, "Pakistan should first tax its own rich before asking for American tax payers' money." Yet like the beggars on our streets who get used to taking insults, the then government continued to look towards Washington for money. There, of course, are no free lunches in this world. The Americans pay only for services required, irrespective of our needs and best interests.

That one good advice from Washington remains unheeded. Like its predecessors, the present government has shown no interest in expanding the tax net by taxing the rich. In a country of over hundred and eighteen million there are only 1.7 million income tax payers. They are either the captive salaried class or the corporate sector.

Meanwhile, ever newer shopping malls selling imported high-end fashion and luxury products keep springing up in big cities like Lahore and Karachi. Even such symbols of affluence as Hermes Birkin bags (price range: $7,400-$150,000) are available. There obviously are enough people in these cities and other parts of the country - including rural areas from where come big landowners dominating our assemblies - to make this activity profitable. Between them, these two cities should have potential taxpayers double the number of the existing national total.

Yet, members of the highest legislative forums at the centre and in the provinces who, among other things, decide bread and butter matters for the entire nation, don't fulfil their own obligations. A large number of them hide behind exemptions they have given themselves. To name a name, KPK Senior Minister Jamaat-e-Islami's Sirajul Haq is among those who don't possess a national tax number. When questioned he justified his position saying he draws a small salary as minister which is not taxable, and that the rest of his income comes from an area which is tax exempt. Many of the present and past legislators claim exemption on similar grounds. For example, the head of Parliament's Public Accounts Committee in the outgoing National Assembly Nadeem Afzal Chann proudly declared during a television discussion a while ago that he had paid Rs 80,000 tax on income earned from a petrol station he owned in an urban area. To those wondering how could anyone with that kind of taxable income make it to the National Assembly, he explained that a large part of his income comes from agriculture which, he said, is not taxable. That in fact is a standard excuse most tax evaders use in the present assemblies.

The claim is based on a half-truth, rather deceit. Agriculture income tax laws do exist in all the four provinces, but they are virtually ineffective. Since majority of the legislators belong to the landed class they have been amending and bending these laws to suit themselves. Under the existing laws, agriculturalists are required to pay tax on the basis of acreage - which basically is land revenue rather than income tax - or progressive rates tax on net income, whichever of the two is higher. Invariably, the anomaly is used to hide real incomes and avert the required payables.

Mindful of the need for reform, the Punjab government recently announced its decision to revise the province's Agricultural Income Tax Act - but after another two years. Since the leadership comes from an urban, industrial background, it may sincerely want to make the necessary changes in the law. But for obvious reasons it is afraid of displeasing rich land owners dominating the assembly. It would be well-advised to remember that for any government to make hard decisions the time is the first year in power. Besides, given the legal bar on floor-crossing, these tax evaders are not going to go away anywhere. Likewise, the other provincial governments, especially Sindh, must do the needful to bring its agriculturalist legislators into the tax net.

Notably, under the election law, wrong declaration of income or assets can lead to disqualification. Misdeclaration of assets is a common affliction, too, among our legislators. The declaratory requirement is applicable not just at the time of filing nomination forms. The candidates also give a signed undertaking that "... failure to give details regarding any item of this form shall render my nomination to contest election invalid, or if any information given herein above is found incorrect at any time, my election shall stand void ab initio." Those making wrong statements under oath clearly are guilty of perjury.

The problem is so widespread that bringing the liers and perjurers to account would upset the entire system. Yet, this must not become an accepted practice. The way out of this unsavoury situation would be to give a one-time amnesty to tax evaders as long as they are willing to clear their dues; and for future to put in place an effective mechanism for the scrutiny of candidates' income and assets declarations. The system of taxing the poor and the captive salaried class to finance the rich as well as the habit of going to foreign friends with a begging bowl must come to a stop.

Ireland

Irish revenue issues reminder on upcoming deadlines

January 1 will be an important date for Irish taxpayers, the Revenue Authority has said, issuing a reminder of its new year deadlines.

A four-year time limit applies to claims for tax refunds. If taxpayers have a claim for the 2009 year, it must be received by Revenue before January 1, 2014. The quickest and easiest way to apply for a refund is to register as a pay-as-you-earn (PAYE) customer and use the service to view and update tax credits, incomes, and rate bands information.

Last year, Revenue refunded over EUR400m in respect of almost 1.1m (USD546.8m) PAYE employee reviews.

Also important to remember is that 2014 local property tax payments are due on or before January 1. The deadline for debit/credit card, cheque or full service provider payment is January 1, but Revenue will treat returns made on or before January 3 as "on time."

If taxpayers wish to benefit from the concession of paying by Single Debit Authority on March 21, or from phased payments by Direct Debit or Deduction at Source, they will need to file a return immediately.

To date, returns have been filed in respect of over 1m properties. Approximately 89 percent have been completed online, and at end-November, EUR287m in LPT had been transferred from Revenue to the Exchequer.

Revenue is currently responding to just over 60,000 items of LPT-related correspondence. Any taxpayer who submitted a genuine query in respect of their 2014 obligations in advance of the November filing deadline will be treated as having complied with their requirements on time, once the query has been resolved and the return filed. – *Courtesy tax-news.com*

Italy

Italian 2014 budget tries out new taxes

On December 23, the Italian parliament approved a "maxi-amendment" which completely replaces the proposals originally made by the Government in its draft 2014 Budget in October, and introduces tax measures that may produce additional revenues to reduce individual tax burdens over the next year.

For the moment, the so-called 2014 “Stability Law” contains only restricted tax cuts, by way, for example, of deductions to individual income tax for employees earning up to EUR55,000 (USD75,300), an increase to the tax incentive for equity contributions from 3 percent to 4.75 percent by 2016, and a rise to 30 percent from 20 percent in the deductibility of local property tax (IMU) against both federal and local corporate income tax for one year.

The Budget has confirmed the restructuring of local taxes from January 1, 2014, whereby IMU is abolished for first non-luxury residences. A new “service tax” to fund all local services, to be called IUC (the unified local tax) will be formed of IMU (levied on the remainder of property owned, including luxury and second houses and commercial and industrial properties.), TASI (a new tax on general local services) and TARI (the current local tax on environmental and waste services).

Additional new measures include that a specific fund will be constituted to reduce tax burdens, to be divided equally between further individual income tax deductions and offsets available to businesses against the regional tax on production. The fund will be topped up with resources deriving from a further rationalization of public expenditure and by action to control tax evasion during the year – the amounts of which presently remain unknown.

However, the biggest innovation in the final version of the Stability Law is said to be the introduction of a “web tax” from January 1, 2014. While a first version of the measure which would have included within its ambit all goods traded over the internet, the approved legislation has been restricted to include an obligation for all purchases of online advertising or copyright in Italy to be effected through a business that is registered for Italian value added tax.

It is still hoped that the “web tax” will compel online multinationals, such as Google, which currently sell advertising through intermediary companies based in countries with lower taxes, to establish a fiscal domicile in Italy.

While it is believed to be the first such tax in the European Union, doubts have been raised that the new tax is compliant with the single market’s non-discrimination rules, and the Government is expected to have to negotiate with the European Commission to ensure its legitimacy. – *Courtesy tax-news.com*

United States

IRS finalizes intergovernmental FATCA data exchange format

The United States Internal Revenue Service (IRS) has finalized the format for automatically exchanging data collected under the Foreign Account Tax Compliance Act (FATCA) data with jurisdictions that have signed an intergovernmental agreement (IGA).

The IGA FATCA XML Schema, posted on the IRS website, is a standard format developed in close cooperation with the OECD, captures required information for reporting of FATCA data from both Foreign Financial Institutions (FFIs) and Host Country Tax Administrations (HCTAs), and will be used for automatic exchange with all FATCA jurisdictions.

The Schema uses elements from existing reporting schemas used by the OECD and the European Union to reduce the burden on reporting entities; uses XML to allow for easier modifications down the road in the event of legislative or regulatory changes in reporting rules; and will facilitate safe and secure electronic data transmission using the International Data Exchange Service (IDES).

The IRS is finalizing IDES to allow for FFIs and HCTAs to exchange FATCA data automatically with the US. It will also allow the US to make reciprocal exchanges where called for by an IGA that is in force.

It is said that IDES: is based on business requirements collected by a multilateral working group; serves as a single point of FATCA information delivery for both FFIs and HCTAs; may be used for automatic exchange with all FATCA jurisdictions; is based on readily-available mature technology; and requires both the file being sent (in the IGA FATCA XML Schema) and the transmission pathway to be encrypted, ensuring the security of tax data. – *Courtesy tax-news.com*

FBR to enforce restaurant monitoring

Thursday, December 26, 2013 - Islamabad—In an apparent bid to bring the big restaurants into tax net, the Federal Board of Revenue (FBR) has decided to enforce Restaurant Invoicemonitoring system (RIMS). The source told here on Wednesday that this decision has been taken when tax authority learnt that hundreds of big hotels in the federal capital are not paying tax on their income. Therefore a new mechanism has been adopted by the FBR and authority has categorized these hotels into four categories for their registration with FBR.

The source said that there are 444 restaurants in the jurisdiction of regional tax office Islamabad and out of these only 115 are tax payers while rest are least bothered to file their sales tax returns. The tax authority has decided to check the income of these hotels. – *Courtesy Pakistan Observer*

Secret tax survey: over 1100 undocumented outlets found in Blue Area

A secret tax survey of the Blue Area, biggest business hub of federal capital revealed 1,106 undocumented businesses/outlets and vendors of electronics/ computer/mobiles, etc, without National Tax Numbers (NTNs) out of 2,246 prominent business establishments in this posh area. Sources told here on Wednesday that the Directorate General of Intelligence and Investigation Inland Revenue conducted this exercise through tax mapping of the Blue Area Islamabad.

Most interesting aspect of the survey was that the special teams of the directorate have conducted surveys of the area without physical interaction with the owners of retail outlets, business establishments and other big sellers of electronics, computers, mobile phones and travel agents, etc. It was a cumbersome exercise to collect details of the businesses without contacting the owners of the businesses. It was also ensured that the survey should be kept secret to intelligently collect necessary data of the biggest business area of the federal capital. Special teams took pictures and made videos of prominent businesses in Blue Area and registered all particulars displayed outside the shops/outlets, etc. The information was collected and dully matched with the tax management system of the FBR to verify the data. Results of the survey revealed that 1,106 businesses, outlets and vendors are not registered with the tax department. They have not even obtained the basic tax document, ie, NTN.

The agency has communicated the information to the FBR for necessary action against the un-registered businesses. These units would be brought into the tax net after fulfilment of legal procedure laid down in the tax laws. It is astonishing to note that the rich businessmen of Blue Area are not ready to obtain NTN. They are not even ready to file income tax returns and wealth statements where applicable. Most of the key businesses have been established in Blue Area without paying any tax in the national kitty.

Sources said that the Directorate General I&I-IR initiated an exercise for discreet tax mapping of the businesses located in Blue Area Islamabad which yielded potentially useful information for checking tax evasion and non-compliance.

Particulars of 2,246 businesses were recorded during the exercise and internally processed by the Directorate General I&I-IR Islamabad. Cross matching of the businesses was carried with the information available on the FBR database to know their tax status.

The exercise has revealed that as many as 1106 businesses of Blue Area Islamabad are not on tax roll. List of these 1106 cases have been shared with the FBR for bringing them into the tax net. On January 17, 2013, Traders Association of Blue Area admitted a loss of Rs 80 million per day which means that their daily income comes to Rs 80 million. This was admitted by the Traders Association of Blue Area in a press conference at the time of long march. The basic compliance of tax was not made by these businessmen making hue and cry on their daily loss due to long-march. The monthly income of Rs 2.4 billion is an extraordinary amount for the shops located in whole of the Blue Area, but they failed to comply with the basic tax laws, sources added. – *Courtesy Business Recorder*

New customs value fixed for headphone, hands-free

For checking massive underinvoicing, Directorate General of Customs Valuation Karachi has fixed $0.30 per piece as new customs value on the import of headphone/earphone/hands-free for mobile for accurate assessment of customs duty. Sources said on Wednesday that the directorate has issued a valuation ruling in exercise of the powers conferred under Section 25-A of the Customs Act, 1969.

It was brought to the notice of Directorate General of Customs Valuation that headphone/earphone/hands-free for mobile were being imported at underinvoiced values causing loss of revenue to government. Therefore, an exercise to determine the customs value of the subject goods under Section 25-A of the Customs Act, 1969 was initiated.

Valuation methods provided in Section 25 of the Customs Act, 1969 were followed. Transaction value method provided in Sub-Section (1) of Section 25 was found inapplicable because requisite information was not available as per law. Identical/similar goods value methods provided in Sub-Section (5) & (6) of Section 25 ibid were also not found applicable for determination of the customs values due to unreliable and variable values, Consequently, findings of market enquiry as envisaged under Sub-Section (7) of Section 25 of the Customs Act, 1969 were adopted to determine custom values for headphone/earphone/hands-free for mobile, ruling said.

Meetings were fixed with the stakeholders. However, no one attended the meetings. Accordingly, results of market enquiry were utilised in terms of Sub-Section (7) of Section 25 of the Customs Act, 1969 to determine the customs values of the goods in question.

In cases where declared/transaction values are higher than the customs value determined in the ruling, the assessing officers shall apply those values in terms of Sub-Section (1) of Section 25 of the Customs Act, 1069. In case of consignments imported by air, the assessing officer shall take into account the differential, between air freight and sea freight while applying the customs values determined in the ruling. The value determined vide the ruling shall be the applicable customs value for assessment of subject imported goods until and unless it is rescinded or revised by the competent authority in terms of Sub-Sections (1) or (3) of Section 25-A of the Customs Act, 1969. – *Courtesy Business Recorder*

Customs value of viscose filament yarn revised

The Collectors of Customs could assess customs duty on the import of viscose filament yarn fine count (below 75 denier) from India and China as per new customs valuation ruling of the Directorate

General of Customs Valuation Karachi. It is learnt that the directorate has revised customs value on the import of viscose filament yarn fine count (below 75 denier), ranging between $5.50 and $8 per kg.

According to the latest ruling, in exercise of the powers conferred under Section 25-A of the Customs Act, 1969, the customs values of fine count "Viscose Filament Yarn 30D to 60D" are determined. The customs value of "Viscose Filament Yarn (75 Denier & Above) were determined under Section 25-A vide Valuation Ruling No 478, dated 19.10.2012. Since the said ruling does not cover viscose filament yarn of the counts (below 75 Denier), therefore, an exercise to determine the customs value of the same under Section 25A of the Customs Act, 1969 was initiated. To determine the customs value, methods given in section 25 of the Customs Act, 1969, were followed. Transaction value method provided in sub-section (a) of section 25 was found inapplicable because sufficient information was not available as per law. Identical/similar goods value methods provided in Sub-sections (5) & (6) of section 25 ibid provided some reference values for determination of the customs values. Deductive value method under Section 25(7) was applied, but it was not found helpful due to undocumented market. Computed value method provided in sub-section (8) of section 25 was not applicable. Therefore, customs value of Viscose Filament Fine Count below 75 Deniers was determined under sub-section (9) of section 25 of the Customs Act, 1969.

Meetings were held with the stakeholders and feedback regarding valuation of subject goods was provided by Pakistan Yarn Merchants Association (Karachi & Gujranwala). In case where declared/transaction values are higher than the customs value determined in this Ruling, the assessing officers shall apply those values in terms of sub-section (1) of section 25 of the Customs Act, 1969. In case of consignments imported by air, the assessing officer shall take into account the differential between air freight and sea freight while applying the customs values determined in this ruling.

The values determined vide this ruling shall be the applicable customs value for assessment of subject imported goods until and unless it is rescinded or revised by the competent authority in terms of sub-section (1) or (3) of Section 25-A of the Customs Act, 1969.

A review petition may be filed against this Ruling, as provided under Section 25-D of the Customs Act, 1969, within 30 days from the date of issue, before the Director, General Directorate General of Customs Valuation, 7th Floor, Customs House, Karachi, it added. The collectors of Customs may ensure that the value given in the Ruling is applied by the concerned staff without fail. The customs values of viscose filament yarn (75 denier and above) determined vide Valuation Ruling No 478, dated 19.10.2012 shall remain applicable for the said goods. – *Courtesy Business Recorder*

First 24 days of December: provisional ST collection stands at Rs 61.834 billion

The provisional sales tax collection stood at Rs 61.834 billion during first 24 days of December 2013 against Rs 47.233 billion in the same period last year, reflecting a handsome increase of 31 percent. Sources told here on Tuesday that the sales tax collection at the import stage was Rs 28.456 billion during the period against Rs 22.418 billion, depicting an increase of 26.9 percent.

Sales tax collection on domestic consumption amounted to Rs 33.377 billion during the first 24 days of December 2013 against Rs 24.816 billion during the corresponding period of last fiscal year, showing an increase of 34.5 percent. The collection of domestic taxes (direct taxes, sales tax and the FED) was Rs 101.551 billion during December 2013 against Rs 80.385 billion in the same period last fiscal, reflecting an increase of 26.3 percent.

The provisional direct taxes collection amounted to Rs 31.650 billion in December 2013 against Rs 26.366 billion during the same period of last fiscal year, showing an improvement of 20 percent. Out of direct taxes collection, withholding tax at the import stage was Rs 6.014 billion during December 2013 against Rs 4.423 billion in the same period last fiscal year.

The customs duty collection stood at Rs 12.421 billion during first 24 days of December 2013 against Rs 11.210 billion in the same period of last fiscal year, reflecting an increase of 10.8 percent. The provisional collection of the Federal Excise Duty (FED) was 8.067 billion during the period under review against Rs 6.787 billion, depicting an increase of 19 percent. The FBR Chairman had reportedly informed the Finance Minister that revenue collected stood at Rs 91.5 billion in December 2013 whereas an amount of Rs 114 billion has been collected in the corresponding period this year, which shows an increase of 25 percent. – *Courtesy Business Recorder*

2013 TRI 2086 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
BANGALORE SPECIAL BENCH, BANGALORE

H.L. Karwa, President,
R.S. Syal, Accountant Member and
N.V. Vasudevan, Judicial Member

FACTS/HELD

SOP discount (difference between market price and issue price) is a deductible expenditure at the time of vesting of the option. An adjustment has to be made if the market price is different at the time of exercise of the option

1. The assessee framed an Employee Stock Option Plan (ESOP) pursuant to which it granted options to its employees to subscribe for shares at the face value of Rs. 10. As the market price of each share was Rs. 919, the assessee claimed that it had given a discount of Rs. 909 which was allowable as a deduction as 'employee compensation. Though the options vested equally over four years, the assessee claimed a larger amount in the first year than was available under the SEBI guidelines. The AO & CIT(A) rejected the claim on the ground that there was no "expenditure". On appeal to the Tribunal, the issue was referred to the Special Bench. HELD by the Special Bench:

   (i) The difference (discount) between the market price of the shares and their issue price is "expenditure" in the hands of the assessee because it is a substitute to giving direct incentive in cash for availing the services of the employees. There is no difference between a case where the company issues shares to the public at market price and pays a part of the premium to the employees for their services and another where the shares are directly issued to employees at a reduced rate. In both situations, the employees stand compensated for their effort. By undertaking to issue shares at a discount, the company does not pay anything to its employees but incurs the obligation of issuing shares at a discounted price at a future date. This is nothing but "expenditure" u/s 37(1);

(ii) The liability cannot be regarded as being "contingent" in nature because the rendering of service for one year is sine qua non for becoming eligible to avail the benefit under the scheme. Once the service is rendered for one year, it becomes obligatory on the part of the company to honor its commitment of allowing the vesting of 25% of the option. The liability is incurred at the end of the first year though it is discharged at the end of the fourth year when the options are exercised by the employees. The fact that some options may lapse due to non-exercise/ resignation etc does not make the entire liability contingent;

(iii) However, the obligation to issue shares at a discounted premium does not arise at the stage the options are granted. It arises at the stage that the options are vested in the employees. The amount deductible has to be determined based on the period and percentage of vesting under the ESOP scheme;

(iv) There is likely to be a difference in the quantum of discount at the stage of vesting of the stock options (when the deduction is allowable) and at the stage of exercise of the options. The difference has to be adjusted by making suitable northwards or southwards adjustment at the time of exercise of the option depending on the market price of the shares then prevailing. The fact that the SEBI Guidelines do not provide for the adjustment of discount at the time of exercise of options is irrelevant because accounting principles cannot affect the position under the Income-tax Act.

(v) On facts, the assessee's method of claiming a larger deduction in the first year defies logic. As the options vest equally over a period of four years, the deduction ought to be claimed in four equal installments on a straight line basis (Ranbaxy Laboratories 124 TTJ 771 (Delhi) reversed, S.S.I. Ltd. v. DCIT 85 TTJ 1049 (Chennai) approved, PVP Ventures 211 Taxman 554 referred. See also Spray Engineering Devices Ltd 53 SOT 70 (Chd)

Order accordingly.

ITA Nos. 368, 369, 370, 371 & 1206/Bang/2010 (Assessment Years : 2003-2004, 2004-2005, 2005-2006, 2006-2007 & 2007-2008) and ITA No. 248/Bang/2010 (Assessment Year : 2004-2005).

Heard on: 27th & 28th June, 2013.

Decided on: 16th July, 2013.

Present at hearing: Padam Chand Khincha, for Appellant. S.K. Ambastha - CIT(DR), for Respondent in ITA Nos.368, 369, 370, 371 & 1206/Bang/2010. S.K. Ambastha - CIT(DR), for Appellant. Padam Chand Khincha, for Respondent in ITA No. 248/Bang/2010.

JUDGMENT

Per R.S. Syal:– (Accountant Member)

The Hon'ble President of the Income Tax Appellate Tribunal has, on a reference made by a Division Bench, constituted this Special Bench for adjudicating the following question of law:

> *"Whether discount on issue of Employee Stock Options is allowable as deduction in computing the income under the head profits and gains of business?"*

2. Since the subject matter of the above question is emanating in almost all the appeals under consideration, for the sake of convenience, we are taking up the factual matrix from the assessment year 2003-2004, which is the first year under reference and for which the leading orders have been passed by the authorities below. Both the sides have also broadly chosen to make submissions with reference to the facts, findings and conclusions drawn in the orders for the assessment year 2003-2004 in which the assessee claimed deduction on account of Employees Compensation under Employees Stock Option Plan (hereinafter called 'the ESOP') for the first time.

3. Briefly stated the facts of the case are that the assessee is engaged in the manufacture of Enzymes and Pharmaceutical ingredients. It formulated the ESOP 2000. A trust was set up under the name and style of "Biocon India Limited Employees Welfare Trust" for giving effect to the ESOP 2000 and another ESOP 2004 which was launched subsequently but during one of the years under consideration. The assessee claimed deduction of Rs. 3,38,63,779 as 'Employee compensation cost' u/s 37 of the Income-tax Act, 1961 (hereinafter called 'the Act') representing discount under the ESOP 2000. In the assessment completed u/s 143(3), the Assessing Officer (hereinafter also called 'the AO') disallowed the said claim on the ground that there was no specific provision entitling the assessee to deduction u/s 37(1) in this regard. He further held that the Securities and Exchange Board of India (Employee Stock Option Scheme And Employee Stock Purchase Scheme) Guidelines, 1999 (hereinafter called 'the SEBI Guidelines' or 'the Guidelines'), on which the assessee had placed strong reliance in support of the deduction, would not apply as

these cannot supersede the taxing principles. Thereafter, a notice u/s 148 was issued and an order dt. 19.12.2008 was passed u/s 143(3) read with section 147. In this order, the Assessing Officer held that the assessee was not entitled to weighted deduction u/s 35(2AB) on the expenditure incurred on software research. This view was canvassed on the premise that in the original order he had held that the expenditure in respect of ESOP was not deductible u/s 37(1), and in that view of the matter there was no point in allowing the weighted deduction on the claim of the assessee for ESOP expenses on account of employees engaged in research activities. He, therefore, made disallowance of Rs. 16.92 lakh in this regard. In the appeal against the said order passed u/s 143(3) read with section 147, the assessee, *inter alia*, assailed the said disallowance of Rs. 16.92 lakh. The learned CIT(A), vide the impugned order dated 13.11.2009, upheld the disallowance of ESOP expenditure of Rs. 3.38 crore, which forms the subject matter of the question before the special bench.

4. Before proceeding further, we want to clarify that the disallowance of Rs. 3.38 crore was made in the original assessment order passed u/s 143(3). As this disallowance stood already made, there could have been no question of taking up this issue again in the reassessment order, which was, *inter alia*, confined to denial of weighted deduction u/s 35(2AB) towards ESOP expenses incurred in relation to employees engaged in software research. Since the learned CIT(A) has decided the question of disallowance of ESOP expenditure of Rs. 3.38 crore in the impugned order, we are refraining from expressing any opinion on the sustainability or otherwise of his action in taking up an issue for decision which did not arise from the order impugned before him. This issue is left to the wisdom of the Division Bench which will pass order on the instant appeals involving other issues as well, having regard to the decision of the special bench on the question reproduced above.

5. Reverting to the question of law posted before us, the facts for the assessment year 2003-2004 are that the assessee-company floated ESOP 2000 under which it granted option of shares with face value of Rs. 10 at the same rate by claiming that the market price of such shares was Rs. 919, thereby claiming the total discount per option at Rs. 909. During the previous year relevant to the assessment year 2003-04, the appellant company granted 71,510 options to its employees. The difference between the alleged market price and the exercise price, at Rs. 909 per option totaling Rs. 6.52 crore was claimed as compensation to the employees to be spread over the vesting period of four years. A deduction of Rs. 3.38 crore was claimed for the assessment year 2003-2004 on the strength of the SEBI Guidelines. It was argued that the claim for deduction was in conformity with the accounting treatment prescribed as per the Schedule I of the Guidelines. The assessee claimed that the employee stock option compensation expense of Rs. 3.38 crore was deductible u/s 37(1) of the Act

as all the requisite conditions were satisfied. To bolster its submission that the amount should be allowed as deduction in accordance with the SEBI Guidelines, the assessee relied on the judgment of the Hon'ble Supreme Court in the case of *Challapalli Sugar Ltd. v. CIT* (1975) 98 ITR 167 (SC) and *CIT v. U.P. State Industrial Development Corporation* (1997) 225 ITR 703 (SC) by contending that these judgments are authorities for the proposition that the accountancy rules also guide the deductibility or otherwise of expenses in the computation of total income. The assessee chiefly relied on the direct order on the issue passed by the Chennai Bench of the Tribunal in the case of *S.S.I. Ltd. v. DCIT* (2004) 85 TTJ (Chennai) 1049 upholding the claim for deduction of discount under ESOP on the basis of the SEBI Guidelines.

6. The authorities below did not accept the assessee's contention of the supremacy of the accounting principles for the purposes of computation of total income. Reliance in this regard was placed on the judgment of the Hon'ble Supreme Court in the case of *Tuticorin Alkali Chemicals & Fertilizers Ltd. v. CIT* (1997) 227 ITR 172 (SC) and *Godhra Electricity Co. Ltd. v. CIT* (1997) 225 ITR 746 (SC). It was noticed that all the options vested over a period of four years from the date of its grant. The physical custody of shares was not with the employees but rested with the trust. The trust was empowered to transfer back the same where the conditions precedent for ESOP were not fulfilled. The options received by the employees were subject to risk of its forfeiture as the eligible employees were required to fulfill number of conditions in an ongoing manner before becoming absolutely entitled to such shares. It was further noticed that the vesting period in this case was four years and an employee must continue to remain in employment so as to be eligible for deduction. In the backdrop of these facts, it was opined that the deduction could be allowed only in respect of real expenditure and not the hypothetical or notional or imaginary expenditure. As no actual expenditure was incurred, the claim for such deduction was denied. The decision in the case of SSI Ltd. (supra) was also distinguished as not applicable to the facts and circumstances of the assessee's case. The assessee is aggrieved against the denial of deduction for discount under ESOP.

7. We have heard Shri H. Padam Chand Khincha for the appellantassessee; Shri Rohit Jain for the Intervener, M/s. Bharti Airtel; Shri Sachin Kumar B.P. for the Intervener, M/s. Advinus Therapeatics Limited ; and Shri K.R.Pradeep for the Intervener, M/s. NDTV Media Limited, (all the four counsel are hereinafter collectively referred to as 'the ld. AR'). We have also heard Shri S.K.Ambastha, the ld. CIT representing the Revenue. The moot question is as to whether the Discounted premium on ESOP also called as the Discount on issue of ESOP or the Employee stock option compensation expense or the Employees compensation expense or simply the Discount etc., is an

allowable deduction in the computation the income under the head "Profits and gains of business or profession"? This larger question can be answered in the following three steps, viz.,

I. Whether any deduction of such discount is allowable ?

II. If yes, then when and how much?

III. Subsequent adjustment to discount

8. We will take up these three steps one by one for consideration and decision.

I. <u>WHETHER ANY DEDUCTION OF SUCH DISCOUNT IS ALLOWABLE ?</u>

9.1. The crux of the arguments put forth by the ld. AR is that discount under ESOP is nothing but employees cost incurred by the assessee for which deduction is warranted. On the other hand, the Revenue has set up a case that no deduction can be allowed as such discount is not only a short capital receipt but also a contingent liability.

<u>A. Is discount under ESOP a short capital receipt?</u>

9.2.1. The ld. DR stated that the question of deduction u/s 37 can arise only if the assessee incurs any expenditure, which thereafter satisfies the requisite conditions of the sub-section (1). He submitted that the word "expenditure" has been described by the Hon'ble Supreme Court in the case of *Indian Molasses Co. Ltd. v. CIT* [(1959) 37 ITR 66 (SC)] as denoting spending or paying out, i.e. something going out of the coffers of the assessee. It was put forth that by issuing shares at discounted premium, nothing is paid out by the company. Once there is no "paying out or away", the same cannot constitute an expenditure and resultantly section 37(1), which applies to only expenditure, cannot be activated. He further took pains in explaining that there is no revenue expenditure involved in the transaction of issuance of ESOP at discount. The so called 'discount' represents the difference between market price of the shares at the time of grant of options and the price at which such options are granted. Since the amount over and above the face value of the shares, being the share premium, is itself a capital receipt, any underrecovery of such share premium on account of obligation to issue shares to employees in future at a lower premium, would be a case of short capital receipt. If at all it is to be viewed in terms of expenditure, then, at best, it would be in the nature of a capital expenditure. He supported his view by relying on the order passed by the Delhi Bench of the Tribunal in *Ranbaxy Laboratories Limited v. Addl. CIT* [ITA Nos. 1855 & 3387/Del/2004] on 12.06.2009. It was stated that the Tribunal in that case has held that since the receipt of share premium is not taxable, any short receipt of such premium on issuing options to employees will be notional loss and not actual loss for which any liability is incurred. The learned Departmental Representative contended that the Mumbai bench of the

Tribunal in the case of *VIP Industries v. DCIT* (ITA No.7242/Mum/2008) has also taken similar view vide its order dated 17.09.2010.

9.2.2. Per contra, the learned AR submitted that it is not a case of any short receipt of share premium but that of compensation given to employees. He supported the admissibility of deduction of the amount of discount on the strength of the order passed by the Chennai bench of the tribunal in the case of SSI Limited (supra) granting deduction of such discount by treating it as an employee cost. He submitted that the above view taken by the Chennai Bench has been approved by the Hon'ble Madras High Court in *CIT v. PVP Ventures Limited* vide its judgment dated 19.06.2012. The learned AR argued that PVP Ventures (supra) is a solitary judgment rendered by any High Court on the issue and hence the same needs to be followed in preference to any contrary Tribunal order. It was also pointed out that the Chennai bench's view has been subsequently followed by the Chandigarh Bench of the Tribunal in *ACIT v. Spray Engineering Devices Limited* ITA No.701/Chd/2009 vide its order dated 22.06.2012.

9.2.3. Let us examine the facts of the case of Ranbaxy Laboratories Limited (supra), which has been strongly relied by the learned Departmental Representative. It deals with a situation in which the assessee granted stock option to its employees. The shares were to be issued at Rs. 559 per share as against the face value of Rs. 10 and the market price on the date of grant at Rs. 738.95 per share. The assessee treated the difference between Rs. 738.95 and Rs. 595 as employees compensation in the books of account and charged the same to its Profit and loss account by spreading it over the vesting period. It was one of the years of the vesting period for which the assessee claimed deduction that came up for consideration before the Tribunal. It was held by the Tribunal that the market price of Rs. 738.55 per share would have resulted in realization of higher share premium. Since the assessee did not account for the difference between Rs. 738.55 and Rs. 10 as its income during the year, there was no loss of income. It was further noticed that by issuing shares at below the market price, there was no incurring of any expenditure. Rather it resulted into short receipt of share premium which the assessee was otherwise entitled to. As the receipt of share premium is not taxable, any short receipt of such premium will only be a notional loss and not actual loss requiring any deduction. The Tribunal further noticed that incurring of such notional loss cannot be considered as expenditure within the meaning of section 37(1) as there was no "spending" or "paying out or away". The contention of the assessee that SEBI Guidelines recommend claim for deduction of discount over the vesting period, did not find favour with the Tribunal on the ground that the SEBI Guidelines were not relevant in determining the total income chargeable to tax.

9.2.4. In order to appreciate the rival submissions, it is of the utmost importance to understand the concept of ESOP. Section 2(15A) of the Indian Companies Act, 1956 defines "employee stock option" to mean '*the option given to the whole-time Directors, Officers or employees of a company, which gives such Directors, Officers or employees, the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price*". In an ESOP, the given company undertakes to issue shares to its employees at a future date at a price lower than the current market price. This is achieved by granting stock options to its employees at discount. The amount of discount represents the difference between market price of the shares at the time of the grant of option and the offer price. In order to be eligible for acquiring the shares under the ESOP, the concerned employees are obliged to render services to the company during the vesting period as given in the scheme. On the completion of the vesting period in the service of the company, such options vest with the employees. The options are then exercised by the employees by making application to the employer for the issue of shares against the options vested in them. The gap between the completion of vesting period and the time for exercising the options is usually negligible. The company, on the exercise of option by the employees, allots shares to them who can then freely sell such shares in the open market subject to the terms of the ESOP. Thus it can be seen that it is during the vesting period that the options granted to the employees vest with them. This period commences with the grant of option and terminates when the options so granted vest in the employees after serving the company for the agreed period. By granting the options, the company gets a sort of assurance from its employee for rendering uninterrupted services during the vesting period and as a *quid pro quo* it undertakes to compensate the employees with a certain amount given in the shape of discounted premium on the issue of shares.

9.2.5. The core of the arguments of the ld. DR in this regard is two-fold. First, that it is not an expenditure in itself and secondly, it is a short capital receipt or at the most a sort of capital expenditure. In our considered opinion both the legs of this contention are legally unsustainable.

9.2.6. There is no doubt that the amount of share premium is otherwise a capital receipt and hence not chargeable to tax in the hands of company. The Finance Act, 2012 has inserted clause (viib) of section 56(2) w.e.f. 1.4.2013 providing that: 'where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares', then such excess share premium shall be charged to tax under the head 'Income from other sources'. But for that, the amount of share premium has always been understood and accepted as a capital receipt. If a company issues shares to the public or the existing shareholders at less than the otherwise prevailing premium due to market sentiment or otherwise, such short receipt of premium would be a case of a receipt of a lower amount on capital account. It is so because the object of issuing such shares at a lower price is nowhere directly connected with the earning of income. It is in such like situation that the contention of the learned Departmental Representative would properly fit in, thereby debarring the company from claiming any deduction towards discounted premium. It is quite basic that the object of issuing shares can never be lost sight of. Having seen the rationale and modus operandi of the ESOP, it becomes out-and-out clear that when a company undertakes to issue shares to its employees at a discounted premium on a future date, the primary object of this exercise is not to raise share capital but to earn profit by securing the consistent and concentrated efforts of its dedicated employees during the vesting period. Such discount is construed, both by the employees and company, as nothing but a part of package of remuneration. In other words, such discounted premium on shares is a substitute to giving direct incentive in cash for availing the services of the employees. There is no difference in two situations viz., one, when the company issues shares to public at market price and a part of the premium is given to the employees in lieu of their services and two, when the shares are directly issued to employees at a reduced rate. In both the situations, the employees stand compensated for their effort. If under the first situation, the company, say, on receipt of premium amounting to Rs. 100 from issue of shares to public, gives Rs. 60 as incentive to its employees, such incentive of Rs. 60 would be remuneration to employees and hence deductible. In the same way, if the company, instead, issues shares to its employees at a premium of Rs. 40, the discounted premium of Rs. 60, being the difference between Rs. 100 and Rs. 40, is again nothing but a different mode of awarding remuneration to employees for their continued services. In both the cases, the object is to compensate employees to the tune of Rs. 60. It follows that the discount on premium under ESOP is simply one of the modes of compensating the employees for their services and is a part of their remuneration. Thus, the contention of the ld. DR that by issuing shares to employees at a discounted premium, the company got a lower capital receipt, is bereft of an force. The sole object of issuing shares to employees at a discounted premium is to compensate them for the continuity of their services to the company. By no stretch of imagination, we can describe such discount as either a short capital receipt or a capital expenditure. It is nothing but the employees cost incurred by the company. The substance of this transaction is disbursing compensation to the employees for their services, for which the form of issuing shares at a discounted premium is adopted.

9.2.7. Now we espouse the second part of the submission of the ld. DR in this regard. He canvassed a view that an expenditure denotes "paying out or away" and unless the money goes out from the assessee, there can be no expenditure so as to qualify for deduction u/s 37. Sub-section (1) of the section provides that any expenditure (not being expenditure in the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession". To put it differently, an expenditure must be laid out or expended wholly and exclusively for the purpose of business so as to be eligible for deduction u/s 37(1). There is absolutely no doubt that section 37(1) talks of granting deduction for an 'expenditure', and the Hon'ble Supreme Court in Indian Molasses Company (supra) has described 'expenditure' to mean what is 'paid out or away' and is something which has gone irretrievably. However, it is pertinent to note that this section does not restrict paying out of expenditure in cash alone. Section 43 contains the definition of certain terms relevant to income from profits of business or profession covering sections 28 to 41. Section 37 obviously falls under Chapter IV-D. Sub-section (2) of section 43 defines "paid" to mean: "actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under the head 'profits and gains of business or profession'." When we read the definition of the word "paid" u/s 43(2) in juxtaposition to section 37(1), the position which emerges is that it is not only paying of expenditure but also incurring of the expenditure which entails deduction u/s 37(1) subject to the fulfillment of other conditions. At this juncture, it is imperative to note that the word 'expenditure' has not been defined in the Act. However, sec. 2(h) of the Expenditure Act, 1957 defines 'expenditure' as : 'Any sum of money or money's worth spent or disbursed or for the spending or disbursing of which a liability has been incurred by an assessee……'. When section 43(2) of the Act is read in conjunction with section 37(1), the meaning of the term 'expenditure' turns out to be the same as is there in the aforequoted part of the definition under section 2(h) of the Expenditure Act, 1957, viz., not only 'paying out' but also 'incurring'. Coming back to our context, it is seen that by undertaking to issue shares at discounted premium, the company does not pay anything to its employees but incurs obligation of issuing shares at a discounted price on a future date in lieu of their services, which is nothing but an expenditure u/s 37(1) of the Act.

9.2.8. Though discount on premium is nothing but an expenditure u/s 37(1), it is worth noting that the Hon'ble Supreme Court in the case of *CIT v. Woodward Governor India (P) Limited* [(2009) 312 ITR 254 (SC)] has gone to the extent of covering "loss" in certain circumstances within the purview of "expenditure" as used in section in 37(1). In that case, the assessee incurred additional liability due to exchange rate fluctuation on a revenue account. The Assessing Officer did not allow deduction u/s 37. When the matter finally reached the Hon'ble Supreme Court, their Lordships noticed that the word "expenditure" has not been defined in the Act. They held that : "the word "expenditure" is, therefore, required to be understood in the context in which it is used. Section 37 enjoins that any expenditure not being expenditure of the nature described in sections 30 to 36 laid out or expended wholly and exclusively for the purposes of the business should be allowed in computing the income chargeable under the head "profits and gains of business or profession". In sections 30 to 36 the expression "expenditure incurred", as well as allowance and depreciation, has also been used. For example depreciation and allowances are dealt with in section 32, therefore, the parliament has used expression "any expenditure" in section 37 to cover both. Therefore, the expression "expenditure" as used in section 37 made in the circumstances of a particular case, covers an amount which is really a "loss" even though the said amount has not gone out from the pocket of the assessee'. From the above enunciation of law by the Hon'ble Summit Court, there remains no doubt whatsoever that the term 'expenditure' in certain circumstances can also encompass 'loss' even though no amount is actually paid out. Ex consequenti, the alternative argument of the ld. DR that discount on shares is 'loss' and hence can't be covered u/s 37(1), also does not hold water in the light of the above judgment. In view of the above discussion, we, with utmost respect, are unable to concur with the view taken in Ranbaxy Laboratories Limited (supra).

<u>B. Is discount a Contingent liability ?</u>

9.3.1. The learned Departmental Representative supported the impugned order by contending that the entitlement to ESOP depends upon the fulfillment of several conditions laid down under the scheme. It is only when all such conditions are fulfilled and the employees render services during the vesting period that the question of any ascertained liability can arise. He submitted that during the entire vesting period, it is only a contingent liability and no deduction is admissible under the provisions of the Act for a contingent liability. The options so granted may lapse during the vesting period itself by reason of termination of employment or some of the employees may not choose to exercise the option even after rendering the services during the vesting period. It was, therefore, argued that the discount is nothing but a contingent liability during the vesting period not calling for any deduction. In the opposition, the learned AR submitted that the amount of discount claimed by the assessee as deduction is not a contingent liability but an ascertained liability. He stated that in the ESOP 2000, there is a vesting period of four years, which means that the options to the extent of 25% of the total grant would vest with the eligible employees at the end of first year after rendering unhindered service for one year and it would go on till the completion of four years.

9.3.2. It is a trite law and there can be no quarrel over the settled legal position that deduction is permissible in respect of an ascertained liability and not a contingent liability. Section 31 of the Indian Contract Act, 1872 defines "contingent contract" as "a contract to do or not do something, if some event, collateral to such contract does not happen". We need to determine as to whether the liability arising on the assessee-company for issuing shares at a discounted premium can be characterized as a contingent liability in the light of the definition of contingent contract. From the stand point of the company, the options under ESOP 2000 vest with the employees at the rate of 25% only on putting in service for one year by the employees. Unless such service is rendered, the employees do not qualify for such options. In other words, rendering of service for one year is sine qua non for becoming eligible to avail the benefit under the scheme. Once the service is rendered for one year, it becomes obligatory on the part of the company to honor its commitment of allowing the vesting of 25% of the option. It is at the end of the first year that the company incurs liability of fulfilling its promise of allowing proportionate discount, which liability would be actually discharged at the end of the fourth year when the options are exercised by the employees. Now the question arises as to whether the liability at the end of each year can be construed as a contingent one?

9.3.3. The Hon'ble Supreme Court in *Bharat Earth Movers v. CIT* [(2000) 245 ITR 428 (SC)] dealt with the deductibility or otherwise of provision for liability towards encashment of earned leave. In that case, the company floated beneficial scheme for its employees for encashment of leave. The earned leave could be accumulated up to certain days. The assessee created provision of Rs. 62.25 lakh for encashment of accrued leave and claimed deduction for the same. The Assessing Officer held it to be a contingent liability and hence not a permissible deduction. When the matter finally came up before the Hon'ble Supreme Court, it was held that the provision for meeting the liability for encashment of earned leave by the employee was an admissible deduction. In holding so, the Hon'ble Apex Court observed that : "*the law is settled : if a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If these requirements are satisfied the liability is not a contingent one. The liability is in praesenti though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be discharged is not certain.*" From the above enunciation of law by the Hon'ble Supreme Court, it is manifest that a definite business liability arising in an accounting year qualifies for deduction even though the liability may have to be quantified and discharged at a future date. We consider it our earnest duty to mention that the legislature has inserted clause (f) to section 43B by providing that "any sum payable by the assessee as an employer in lieu of any leave at the credit of his employee" shall be allowed as deduction in computing the income of the previous year in which such sum is actually paid. With this legislative amendment, the application of the ratio decidendi in the case of Bharat Earth Movers (supra) to the provision for leave encashment has been nullified. However, the principle laid down in the said judgment is absolutely intact that a liability definitely incurred by an assessee is deductible notwithstanding the fact that its quantification may take place in a later year. The mere fact that the quantification is not precisely possible at the time of incurring the liability would not make an ascertained liability a contingent.

9.3.4. Almost to the similar effect, there is another judgment of the Hon'ble Supreme Court in the case of *Rotork Controls India (P) . CIT* [(2009) 314 ITR 62 (SC)]. In that case, the assessee-company was engaged in selling certain products. At the time of sale, the company provided a standard warranty that in the event of certain part becoming defective within 12 months from the date of commissioning or 18 months from the date of dispatch, whichever is earlier, the company would rectify or replace the defective parts free of charge. This warranty was given under certain conditions stipulated in the warranty clause. The assessee made a provision for warranty at Rs. 5.18 lakh towards the warranty claim likely to arise on the sales effected by the assessee. The Assessing Officer disallowed the same on the ground that the liability was merely a contingent liability and hence not allowable as deduction u/s 37 of the Act. When the matter finally came up before the Hon'ble Supreme court, it entitled the assessee to deduction on the "accrual" concept by holding that a provision is recognized when : "*(a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation : and (c) a reliable estimate can be made of the amount of the obligation*". Resultantly, the provision was held to be deductible.

9.3.5. When we consider the facts of the present case in the backdrop of the ratio laid down by the Hon'ble Supreme Court in Bharat Earth Movers (supra) and Rotork Controls India P. Ltd. (supra), it becomes vivid that the mandate of these cases is applicable with full force to the deductibility of the discount on incurring of liability on the rendition of service by the employees. The factum of the employees becoming entitled to exercise options at the end of the vesting period and it is only then that the actual amount of discount would be determined, is akin to the quantification of the precise liability taking place at a future date, thereby not disturbing the otherwise liability which stood incurred at the end of the each year on availing the services.

9.3.6. As regards the contention of the ld. DR about the contingent liability arising on account of the options lapsing during the vesting period or the employees not choosing to exercise the option, we find that normally it is provided in the schemes of ESOP that the vested options that lapse due to non-exercise and/or unvested options that get cancelled due to resignation of the employees or otherwise, would be available for grant at a future date or would be available for being re-granted at a future date. If we consider it at micro level qua each individual employee, it may sound contingent, but if view it at macro level qua the group of employees as a whole, it loses the tag of 'contingent' because such lapsing options are up for grabs to the other eligible employees. In any case, if some of the options remain unvested or are not exercised, the discount hitherto claimed as deduction is required to be reversed and offered for taxation in such later year. We, therefore, hold that the discount in relation to options vesting during the year cannot be held as a contingent liability.

C. Fringe benefit

9.4.1. There is another important dimension of this issue. Chapter XII-H of the Act consisting of sections 115W to 115WL with the caption : "Income-Tax on Fringe Benefits" has been inserted by the Finance Act, 2005 w.e.f. 1.4.2006. Memorandum explaining the provisions of the Finance Bill, 2005 highlights the details of the Fringe Benefits Tax. It provides that : 'Fringe benefits as outlined in section 115WB, mean any privilege, service, facility or amenity directly or indirectly provided by an employer to his employees (including former employees) by reason of their employment.' Charging section 115WA of this Chapter provides that : "In addition to the income-tax charged under this Act, there shall be charged for every assessment year……….fringe benefit tax in respect of fringe benefits provided or deemed to have been provided by an employee to his employees during the previous year…………". Section 115WB gives meaning to the expression 'Fringe Benefits'. Subsection (1) provides that for the purposes of this Chapter, 'fringe benefits' means any consideration for employment as provided under clauses (a) to (d). Clause (d), which is relevant for our purpose, states that : 'any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost or at concessional rate to his employees (including former employee or employees)' shall be taken as fringe benefit. Explanation to this clause clarifies that for the purposes of this clause,— (i) "specified security" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and, where employees' stock option has been granted under any plan or scheme thereof, includes the securities offered under such plan or scheme. Thus it is discernible from the above provisions of the Act that the legislature itself contemplates the discount on premium under ESOP as a benefit provided by the employer to its employees during the course of service. If the legislature considers such discounted premium to the employees as a fringe benefit or 'any consideration for employment', it is not open to argue contrary. Once it is held as a consideration for employment, the natural corollary which follows is that such discount i) is an expenditure; ii) such expenditure is on account of an ascertained (not contingent) liability ; and iii) it cannot be treated as a short capital receipt. In view of the foregoing discussion, we are of the considered opinion that discount on shares under the ESOP is an allowable deduction.

II. IF YES, THEN WHEN AND HOW MUCH?

10.1. Having seen that the discount under ESOP is a deductible expenditure u/s 37(1), the next question is that 'when' and for 'how much' amount should the deduction be granted ?

10.2. The assessee is a limited company and hence h it is obliged to maintain its accounts on mercantile basis. Under such system of accounting, an item of income becomes taxable when a right to receive it is finally acquired notwithstanding the fact that when such income is actually received. Even if such income is actually received in a later year, its taxability would not be evaded for the year in which right to receive was finally acquired. In the same manner, an expense becomes deductible when liability to pay arises irrespective of its actual discharge. The incurring of liability and the resultant deduction cannot be marred by mere reason of some difficulty in proper quantification of such liability at that stage. The very point of incurring the liability enables the assessee to claim deduction under mercantile system of accounting. We have noticed the mandate of the Hon'ble Supreme Court in Bharat Earth Movers (supra) that if a business liability has definitely arisen in an accounting year, then the deduction should be allowed in that year itself notwithstanding the fact that such liability is incapable of proper quantification at that stage and is dischargeable at a future date. It follows that the deduction for an expense is allowable on incurring of liability and the same cannot be disturbed simply because of some difficulty in the proper quantification. A line of distinction needs to be drawn between a situation in which a liability is not incurred and a situation in which the liability is incurred but its quantification is not possible at the material time. Whereas in the first case, there cannot be any question of allowing deduction, in the second case, deduction has to be allowed for a sum determined on some rational basis representing the amount of liability incurred.

10.3. We have earlier underlined the concepts of grant of options, vesting of options and exercise of options. The period from grant of option to the vesting of option is the 'vesting period'. It is during such period that an employee is supposed to render service to the company so as to earn an entitlement to the shares at a discounted premium. The vesting period may vary from a case to case. If the vesting period is, say, four years with equal vesting at the end of each year, then it is at the end of the vesting period or during the exercise period, which in turn immediately succeeds the vesting period, that the employee becomes entitled to exercise 100 options or qualify for receipt of 100 shares at discount. Though the shares are allotted at the end of the vesting period, but it is during such vesting period that the entitlement is earned. It means that 25 options vest with the employee at the end of each year on his rendering service for the respective year. If during the interregnum, he leaves the service, say after one year, he will still remain entitled to exercise option for 25 shares at the discounted premium at the time of exercise of option. In that case, the benefit which would have accrued to him at the end of the second, third and fourth years would stand forfeited. Thus it becomes abundantly clear that an employee becomes entitled to the shares at a discounted premium over the vesting period depending upon the length of service provided by him to the company. In all such schemes, it is at the end of the vesting period that option is exercisable albeit the proportionate right to option is acquired by rendering service at the end of each year.

10.4. Similar is the position from the stand point of the company. An obligation falls upon the company to allot shares at the time of exercise of option depending upon the length of service rendered by the employee during the vesting period. The incurring of liability towards the discounted premium, being compensation to employee, is directly linked with the span of service put in by the employee. In the above illustration, when 25 out of 100 shares vest in the employee after rendering one year's service, the company also incurs equal obligation at the end of the first year for which it becomes entitled to rightfully claim deduction u/s 37(1) of the Act. Similarly at the end of the second year of service by the employees, the company can claim deduction for discounted premium in respect of further 25 shares so on and so forth till fourth year when the last tranche of discounted premium in respect of 25 shares becomes available for deduction. It, therefore, transpires that a company under the mercantile system can lawfully claim deduction for total discounted premium representing the employees cost over the vesting period at the rate at which there is vesting of options in the employees.

10.5. From the above discussion it is lucid that at the event of granting options, the company does not incur any obligation to issue the shares at discounted premium. Mere granting of option does neither entitle the employee to exercise such option nor allow the company to claim deduction for the discounted premium. It is during the vesting period that the company incurs obligation to issue discounted shares at the time of exercise of option. Thus the event of granting options does not cast any liability on the company. On the other end is the date of exercising the options. Though the employees become entitled to exercise the option at such stage but the fact is that it is simply a result of vesting of options with them over the vesting period on the rendition of services to the company. In other words, it is a stage of realization of income earned during the vesting period. In the same manner, though the company becomes liable to issue shares at the time of the exercise of option, but it is in lieu of the employees compensation liability which it incurred over the vesting period by obtaining their services. From the above it is apparent that the company incurs liability to issue shares at the discounted premium only during the vesting period. The liability is neither incurred at the stage of the grant of options nor when such options are exercised.

10.6. Let us consider the facts of the case of SSI Industries Ltd. (supra), which has been strongly relied by the ld. AR in support of his claim for deduction of discount during the years of vesting of options. In that case the vesting period was three years and the assessment order was passed u/s 143(3), inter alia, allowing deduction of Rs. 66.82 lakh under the head "Staff welfare expenses" on account of amortization of discounted value of option over a period of three years. The CIT revised such order by directing the A.O. to disallow ESOP expenditure of Rs. 66.82 lakh. When the matter came up before the Tribunal, it was held that the expenditure in that behalf was an ascertained liability and not contingent upon happening of certain events. It was further noticed that the assessee claimed deduction of such discount on ESOP by following the SEBI Guidelines. As the expenditure itself was an ascertained liability, the Tribunal held that the same to be deductible.

10.7. Before proceeding further it would be befitting to take stock of the nutshell of the SEBI Guidelines in this regard. These Guidelines provide for granting of deduction on account of discount on issue of options during the vesting period. It has been so explained with the help of an example in Schedule I to the Guidelines. For the sake of simplicity, we are taking an instance under which an option of share with face value of Rs. 10 is given under ESOP to employees at the option price of Rs. 10 as against the market price of such shares at Rs. 110 on that date. Further suppose that the vesting period is four years with equal vesting @ 25% at the end of each year. Total discount comes to Rs. 100 (Rs. 110 – Rs. 10). These Guidelines provide for claiming deduction in the accounts for a total discount of Rs. 100 divided over the vesting period of four years on straight line basis at the rate of Rs. 25 each. The case of SSI Limited (supra) deals with a controversy relating to one of the vesting years. The tribunal entitled the assessee to proportionate deduction. Thus it is evident that the view taken by the tribunal in that case not only matches with the SEBI Guidelines but also the 'accrual concept' in the mercantile system of accounting, thereby allowing deduction at the stage of incurring of liability.

10.8. Reverting to the questions of 'when' and 'how much' of deduction for discount on options is to be granted, we hold that the liability to pay the discounted premium is incurred during the vesting period and the amount of such deduction is to be found out as per the terms of the ESOP scheme by considering the period and percentage of vesting during such period. We, therefore, agree with the conclusion drawn by the tribunal in SSI Ltd.'s case allowing deduction of the discounted premium during the years of vesting on a straight line basis, which coincides with our above reasoning.

III. SUBSEQUENT ADJUSTMENT TO DISCOUNT

11.1.1. Having answered the first major issue in affirmative that the discount on options under ESOP is an ascertained liability and the second major issue that the discount is deductible over the vesting period on straight line basis unless the vesting is not uniform, then arises the present issue as to whether any subsequent adjustment is warranted at the time of exercise of options, to the deductions earlier allowed for the amount of discount. It is noticed that the assessment years 2003-2004 to 2007-2008 are under consideration and during these years ESOP 2000 has come to an end and the ESOP 2004 has started. Further, the extant issue is a vital part of the overall question of the deductibility or otherwise of the amount of discount under ESOP.

11.1.2. We have noticed above that the company incurs a definite liability during the vesting period, but its proper quantification is not possible at that stage as the actual amount of employees cost to the company, can be finally determined at the time of the exercise of option or when the options remain unvested or lapse at the end of the exercise period. It is at this later stage that the provisional amount of discount on ESOP, initially quantified on the basis of market price at the time of grant of options, needs to be suitably adjusted with the actual amount of discount.

11.1.3. As regards the adjustment of discount when the options remain unvested or lapse at the end of the exercise period, it is but natural that there is no employee cost to that extent and hence there can be no deduction of discount *qua* such part of unvested or lapsing options. But, as the amount was claimed as deduction by the company during the period starting with the date of grant till the happening of this event, such discount needs to be reversed and taken as income. It is so because logically when the options have not eventually vested in the employees, to that extent, the company has incurred no employee cost. And if there is no cost to the company, the tentative amount of deduction earlier claimed on the basis of the market price at the time of grant of option ceases to be admissible and hence needs to be reversed. The ld. AR stated that the discount in respect of the unvested/lapsing options has been reversed on the happening of such events and the overall employee cost has been correspondingly reduced. We find that the SEBI Guidelines also provide that the discount written off in respect of unvested options and the options lapsing at the end of the exercise period shall be reversed at the appropriate time. As the accounting treatment directed through the Guidelines accords with the taxation principle of not allowing deduction for the amount of discount on unvested/lapsing options and further the assessee has admitted to have offered such amount as income in the relevant years, we stop here by holding that the amount of discount claimed as deduction earlier in respect of unvested/lapsing options, has to be taxed as income on the happening of such events.

11.1.4. Now we take up the second situation in which the options are exercised by the employees after putting in service during the vesting period. In such a scenario, the actual amount of remuneration to the employees would be only the amount of actual discounted premium at the time of exercise of option. The Hon'ble Supreme Court in the case of *CIT v. Infosys Technologies Limited* [(2008) 297 ITR 167 (SC)] relevant to the assessment years 1997-98 to 1999-2000 has held that the allotment of shares to employees under ESOP subject to a lock in period of five years and other conditions could not be treated as a perquisite as there was no benefit and the value of benefit, if any, was unascertainable at the time when options were exercised. The Finance Act, 1999 inserted section 17(2)(iiia) with effect from 1st April, 2000 providing that : "the value of any specified security allotted or transferred, directly or indirectly, by any person free of cost or at a concessional rate to an individual who is or has been in employment of that person" shall be treated as a perquisite. It further provides that in a case the allotment or transfer of specified securities is made in pursuance of an option exercised by an individual, the value of the specified securities shall be taxable in the previous year in which such option is exercised by such individual. Such clause (iiia) was subsequently deleted with effect from 1st April, 2001. After certain changes to the relevant provisions in this regard, the position which now stands is that the discount on ESOP is taxable as perquisite u/s 17(2)(vi) for : 'the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee'. Clause (c) of Explanation to section 17(2)(vi) provides that : ' the value of any specified security or sweat equity shares shall be the fair market value of the specified security or sweat equity shares, as the case may be, on the date on which the option is exercised by the assessee as reduced by the amount actually paid by, or recovered from, the assessee in respect of such security or shares'. Two things surface from the above provisions. First, that the perquisite arises on the 'allotment' of shares and second, the value of such perquisite is to be computed by considering the fair market value of the shares on 'the date on which the option is exercised' by the assessee as reduced by the amount actually paid. The position that such amount was or was not taxable during some of the years in the hands of the employees is not relevant in considering the occasion and the amount of benefit accruing to the employee under ESOP. Any exemption or the deductibility of an allowance or benefit to employee from taxation does not obliterate the benefit itself. It simply means that the benefit accrued to the assessee but the same did not attract tax. The position has now been clarified beyond doubt by the legislature that the ESOP discount, which is nothing but the reward for services, is a taxable perquisite to the employee at the time of exercise of option, and its valuation is to be done by considering the fair market value of the shares on the date on which the option is exercised.

11.1.5. The other side of the coin is the amount of remuneration to the employees in the hands of the company. We have noticed earlier that an expense becomes deductible on the incurring of liability under the mercantile system of accounting. Although the stage of taxability of perquisite in the hands of the employee may differ from the stage of the deductibility of expense in the hands of the company depending upon the method of account followed by the company, but the amount of such discount or employees remuneration can never be different. If the value of perquisite in the hands of the employee, whether or not taxable, is 'x', then its cost in the hands of the company has also to be 'x'. It can neither be 'x+1' nor 'x-1'. It is simple and plain that the amount of remuneration which percolates to the employees will always be equal to the amount flowing from the company and such remuneration to the employee in the present context is the amount which he actually becomes entitled to on the exercise of options. Thus, 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.

11.1.6. The amount of discount at the stage of granting of options w.r.t. the market price of shares at the time of grant of options is always a tentative employees cost because of the impossibility in correctly visualizing the likely market price of shares at the time of exercise of option by the employees, which, in turn, would reflect the correct employees cost. Since the definite liability is incurred during the vesting period, it has to be quantified on some logical basis. It is this market price at the time of the grant of options which is considered for working out the amount of discount during the vesting period. But, since actual amount of employees cost can be precisely determined only at the time of the exercise of option by the employees, the provisional amount of discount availed as deduction during the vesting period needs to be adjusted in the light of the actual discount on the basis of the market price of the shares at the time of exercise of options. It can be done by making suitable northwards or southwards adjustment at the time of exercise of option. This can be explained with the following example with the assumption of vesting period of four years and the benefit vesting at 25% each at the end of 1st to 4th years:–

	At the time of granting option	At the time of exercise of option		
		Situation I	Situation II	Situation III
Market value per share	110	110	130	90
Option price	10	10	10	10
Employees compensation or Discount	100	100	120	80

11.1.7. From the above table it can be noticed that the market price of the shares at the time of grant of option was Rs. 110 against the option price of Rs. 10, which resulted in discount at Rs. 100. With the vesting period of four years with the equal vesting, the company can rightly claim deduction at the rate of Rs. 25 each at the end of first, second, third and fourth year of vesting. But this total deduction for discount of Rs. 100 over the vesting period needs to be adjusted at the time of exercise of option by the employee when the shares are issued. In Situation I, the market price of shares at the time of exercise of option is at Rs. 110, which is similar to the market price at the time of grant of option. As the total amount of discount of Rs. 100 over the vesting period is actually quantified at Rs. 100, no further adjustment to the discount is required at the time of exercise of option. In Situation II, the market price of the share at the time of exercise of option has gone up to Rs. 130. The amount of real compensation to employee is Rs. 120 as against the tentative compensation of Rs. 100 per share which was accounted for and allowed as deduction during the vesting period. As the actual quantification of the compensation has turned out to be Rs. 120, the company is entitled to a further deduction of Rs. 20 at the time of exercise of option. In Situation III, the market price of the share at the time of exercise of option has come down to Rs. 90. The amount of real compensation to employees is Rs. 80 as against the tentative compensation of Rs. 100, which was allowed as deduction during the vesting period. As the actual quantification of the compensation has turned out to be Rs. 80, the company is liable to reverse the deduction of Rs. 20 at the time of exercise of option.

Taxation vis-à-vis Accountancy principles

11.2.1. It has been noticed that broadly there are three stages having effect on the total income of the company in the life cycle of ESOP, viz., i) during the vesting period, ii) at the time of unvesting/lapse of options and iii) finally at the time of exercise of options. It has been argued that the assessee company claimed deduction for the amount of discount during the vesting period on the basis of the market price of shares at the time of grant of options and also reversed the proportionate discount on unvesting/lapsing of options at the appropriate time on the basis of the SEBI Guidelines. If this contention is correct, it would mean that the first two stages have been rightly given effect to. But the appellant assessee does not appear to have made any downward adjustment to the amount of discount at the time of exercise of option by the employees with the difference in the market price of the shares at the time of grant of option and price at the time of exercise of option. The argument seems to be that the SEBI Guidelines do not provide for such downward adjustment. It has been argued by the ld. AR that where the provisions of the Act specifically provide for treatment of a particular source of income in a particular manner, then the germane provision should be followed. If, however, there is no specific provision dealing with an issue in the Act, then the accounting principles should be adhered to while determining the total income of the assessee. In this regard, he relied on the judgment in the case of Challapalli Sugars Ltd.'s [supra] , wherein the Hon'ble Supreme Court has held that the interest payable on capital borrowed by the assessee for purchase of plant and machinery before the commencement of business should be capitalized on the basis of accepted accountancy rule. Similarly in the case of U.P. State Industrial Development Corporation (supra), the Hon'ble Apex Court held in the case of an underwriter that it would be right to consider the net investment, that is the purchase price less the underwriting commission received by the underwriter as investment as against treating the gross amount by taking into consideration the principles of commercial accounting. He stated that since there is no specific provision in the Act providing for the treatment of discount on ESOP in the computation of total income, the accounting principles formulated by way of the SEBI Guidelines are required to be followed.

11.2.2. In the oppugnation, the learned Departmental Representative submitted that the SEBI Guidelines cannot mandate the deductibility or otherwise of an amount under the provisions of the Act. He relied on the judgments of the Hon'ble Supreme Court in Tuticorin Alkali Chemicals & Fertilizers Ltd. (supra) and Godhra Electricity Company Ltd. (supra) in support of this proposition.

11.2.3. We are not persuaded by the submissions put forth by the ld. AR that, in the absence of any specific provision in the Act, the accounting principles should be followed for determining the total income of the assessee. What is true for accounting purpose need not necessarily be true for taxation. Taxation principles are enshrined in the legislature. Power to legislate lies with the Parliament. Accounting standards or Guidance Note or Guidelines etc., by whatever name called, issued by any autonomous or even statutory bodies including the Institute of Chartered Accountants of India, or for that matter, the SEBI are meant only to prescribe the way in which the transactions should be recorded in books or reflected in the annual accounts. These guidelines do not have the force of an Act of Parliament. Since the subject matter of tax on income falls in the Union List as per Part XI of the Indian Constitution, it is only the Parliament which can legislate on its scope.

11.2.4. Be that as it may, there is no weight in the contention of the ld. AR that there is no specific provision in the Act on the ESOP discount. It is axiomatic that the taxation rules are always embodied in the relevant Act, either in a specific or a general manner. These can be specific by making a clear cut provision in respect of deductibility of a particular item of expense or taxation of a particular item of income. General provisions are those which set out the overall principles to govern the deductibility or taxability of unspecified items. For example, the definition of 'income' u/s 2(24) has been given by the Act in an inclusive manner. There have been enshrined clauses (i) to (xvi) dealing with the items specifically listed. However, the provision has been couched in such a way so as to include general items of receipts having character of income, even though not specifically mentioned. Similar is the position regarding deductions. Under the head 'Profits and gains of business or profession', there are sections granting deductions in respect of specific expenses or allowances. Similarly, there is section 37(1), which grants deduction for expenses not specifically set out in other sections, if the conditions stipulated in the section, are fulfilled. All other items of expenses, which fulfill the requisite conditions, gain deductibility under section 37(1). To put it in simple words, this section is a specific provision for granting deduction in respect of the unspecified or the general categories of expenses. Discount on ESOP is a general expense and hence covered by the specific provision of section 37. The contention of the ld. AR that there is no provision in the Act dealing with the deductibility of ESOP discount, is therefore, devoid of any merit. This concludes the question of granting of deduction of discount during the vesting period.

11.2.5. The SEBI Guidelines have been taken shelter of to contend that there is no requirement for the adjustment of discount at the time of exercise of options. Primarily, we are unable to trace the proposition anywhere from the Act that the accounting principles are also determinative of the tax liability. The jurisprudence is rather the other way around. In Tuticorin Alkali Chemicals & Fertilizers Ltd. (supra), the Hon'ble Supreme Court has laid down in so many words that the taxing principles cannot walk on the footsteps of the accounting principles. At this juncture, it would be useful to have a glimpse at the following observations of the Hon'ble Supreme Court in the afore noted case: 'It is true that this court has very often referred to accounting practice for ascertainment of profit made by a company or value of the assets of a company. But when the question is whether a receipt of money is taxable or not or whether certain deductions from that receipt are permissible in law or not, the question has to be decided according to the principles of law and not in accordance with accountancy practice. Accounting practice cannot override section 56 or any other provision of the Act. As was pointed out by Lord Russell in the case of B. S. C. Footwear Ltd. [1970] 77 ITR 857, 860 (CA), the income-tax law does not march step by step in the footprints of the accountancy profession.'

11.2.6. The same view has been adopted by the Hon'ble Supreme Court in Godhra Electricity Company Ltd. (supra), by holding that : 'Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, viz., the accrual of the income or its receipt; but the substance of the matter is the income. If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a hypothetical income, which does not materialise.'

11.2.7. It follows that accounting principles have absolutely no role to play in the matter of determination of total income under the Act. If an accounting principle is referred to by the higher judiciary, then there is an underlying presumption that such accounting principle is in conformity with and not in conflict with the taxation principle. The essence of the matter is that taxation principles are to be followed. If an accounting principle is in conformity with the mandate of taxing principle and reference is made to such accounting principle while deciding the issue, it does not mean that the accounting principle has been followed. It simply means that the taxation principle has been followed and the accounting principle, which is in line with such taxation principle, has been simply taken note of. If however, an accounting principle runs counter to the taxation principle, then there is no prize for guessing that it is only the taxation principle which shall prevail.

11.2.8. The plea now raised before us by the ld. AR, relying on the case of Challapalli Sugars Ltd.'s case, was also taken up before the Hon'ble Supreme Court in the case of Tuticorin Alkalis (supra). Dealing with the same, the Hon'ble Supreme Court held that : "The question in *Challapalli Sugars Ltd.*'s case [1975] 98 ITR 167 (SC) was about computation of depreciation and development rebate under the Indian Income-tax Act, 1922. In order to calculate depreciation and development rebate it was necessary to find out "the actual cost" of the plant and machinery purchased by the company. This court held that "cost" is a word of wider connotation than "price". There was a difference between the price of a machinery and its cost. This court thereafter pointed out that the expression "actual cost" had not been defined in the Act. It was, therefore, necessary to find out the commercial sense of the phrase. …………The judgment in Challapalli's case [1975] 98 ITR 167 (SC), goes to show that the court was not in any way departing from legal principles because of any opinion expressed by the Institute of Chartered Accountants." From the above observations there is not even an iota of doubt in our minds that there can be no question of following the accounting principle or Guidance notes etc. in the matter of determination of total income.

11.2.9. The trump card of the ld. AR to bolster his submission for assigning the status of binding force to the SEBI Guidelines is the order in the case of SSI Limited (supra) which came to be affirmed by the Hon'ble Madras High Court in PVP Ventures (supra). We have noticed above that the said case dealt a situation falling within one of the three years of the vesting period, in which it was held that one third of the total amount of discount computed on the basis of the market price of the shares at the time of grant of option, is deductible. It is evident from the SEBI Guidelines that these deal with the deductibility of discount in the hands of company during the years of vesting period. These Guidelines are silent on the position emanating from variation in the market price of the shares at the time of exercise of option by the employees vis-à-vis the market price at the time of grant of option. In other words, the SEBI Guidelines prescribe accounting treatment only in respect of the period of vesting of the options and the situation arising out of unvested options or vested options lapsing. The very reference by the Chennai Bench of the Tribunal in SSI Limited (supra) to the SEBI Guidelines is indicative of the fact that it dealt with a year during which the options were vesting with the employees and the company claimed discount during the vesting period. The Hon'ble Madras High Court in the case of PVP Ventures (supra) has upheld the view taken by the Chennai Bench in the case of SSI Limited (supra). The granting of the binding force to the SEBI Guidelines by the Hon'ble Madras High Court should be viewed in the context of the issue before it, which was about the deductibility of discount during one of the vesting years. In the earlier part of this order, we have held that the deductibility of discount during the vesting period, as prescribed under the SEBI Guidelines, matches with the treatment under the mercantile system of accounting. To that extent, we also hold that the SEBI guidelines are applicable in the matter of deduction of discount. Neither there was any issue before the Hon'ble Madras High Court nor it dealt with a situation in which the market price of the shares at the time of exercise of option is more or less than the market price at the time of grant of option. It is a situation which has also not been dealt with by the Guidelines. Accordingly, the aforenoted taxation principle of granting deduction for the additional discount and reversing deduction for the short amount of discount at the time of exercise of option, needs to be scrupulously followed.

11.3. We, therefore, sum up the position that the discount under ESOP is in the nature of employees cost and is hence deductible during the vesting period w.r.t. the market price of shares at the time of grant of options to the employees. The amount of discount claimed as deduction during the vesting period is required to be reversed in relation to the unvesting/lapsing options at the appropriate time. However, an adjustment to the income is called for at the time of exercise of option by the amount of difference in the amount of discount calculated with reference the market price at the time of grant of option and the market price at the time of exercise of option. No accounting principle can be determinative in the matter of computation of total income under the Act. The question before the special bench is thus answered in affirmative by holding that discount on issue of Employee Stock Options is allowable as deduction in computing the income under the head 'Profits and gains of business or profession'.

SOME RELEVANT FACTORS IN ASSESSEE'S CASE

12.1. Having answered the question in affirmative, let us examine its applicability to the facts of the appellant's case. It has been seen above that the authorities below refused to grant deduction of the discount at the very threshold. Resultantly, the verification of the correctness of calculation of discount stood ousted. Since we have overturned such view in above terms, the verification of calculation in accordance with our directions becomes imperative. We, therefore, set aside the impugned orders on this issue and remit the matter to the file of the AO for finding out the correct amount of deduction accordingly.

12.2. It would be imperative to highlight certain points having bearing on the issue which have come to our notice during the course of hearing. The AO is directed to look, *inter alia*, into these aspects in quantifying the amount of eligible deduction.

a. The assessee-company was a closely held company in the previous year relevant to the assessment year 2003-2004 and as such there was no question of the listing of its shares and having some market price at the time of grant of options. Ordinarily, the amount of discount on premium which is written off over the vesting period represents the market price of the shares listed on the stock exchange on the date of grant of option as reduced by the price at which option is given to the employees. However, presently there is no availability of any market price of such shares on the date of grant of option as the company came to be listed on a stock exchange in a subsequent year. On a pointed query, the ld. AR furnished the details of such claim by showing that it granted 71,510 options with discount of Rs. 909 per option making total discount at Rs. 6.50 crore. He stated that the face value of shares is at Rs. 10 against which the deduction for discounted premium over the vesting period has been claimed at Rs. 909, meaning thereby that the market price of the share on the date of grant of option was taken at Rs. 919. No material worth the name has been placed on record to indicate as to how a share with face value of Rs. 10 has been valued at Rs. 919 for claiming deduction towards discount at Rs. 909 per share. This aspect of valuation of shares at Rs. 919 per share needs to be examined by the Assessing Officer.

b. We have held above that the deduction of the discounted premium is to be claimed over the vesting period. The assessee claimed deduction for discount amounting to Rs. 3.38 crore for the A.Y. 2003-04. On being called upon to furnish bifurcation of such claim, the assessee filed a chart showing its detail comprising of four amounts. First amount of Rs. 1.62 crore has been shown as the first tranche of 25% option. Second amount of Rs. 81.25 lakh as the second tranche of 25% option; third amount of Rs. 54.16 lakh as the third tranche of 25% option and the last amount of Rs. 40.62 lakh as the fourth tranche of 25% option. We are unable to understand as to how the last three amounts can qualify for deduction at the end of the first year itself. On a specific query, it was stated by the ld. AR that the assessee claimed deduction for the proportionate part of discount for the second, third and fourth year at the end of the first year itself because 25% of options vested in the employees at the end of the first to fourth year each. This defies all logics and rationalities. When the options vest equally over a period of four years, it is but natural that the company would incur equal liability for the discounted premium @ 25% of total discount on receipt of services of the employees at the end of each year. The way in which the assessee has claimed deduction runs contrary even to the SEBI Guidelines, which also provide for deduction on straight line basis. The manner of the assessee's claiming deduction has resulted in needlessly increasing the amount of deduction for the first year at the cost of deduction for the subsequent three years. It needs to be set right by apportioning the total amount of the discounted premium evenly over the vesting period of four years.

c. It has been noticed above that the stage for the grant of deduction of discount is on the respective vesting of the options. In ESOP 2000, the vesting takes place @ 25% after each year of service. It means that the first part of 25% deduction would be available on the completion of one year from the date of grant of option. The assessee was required to indicate the date of grant of options in respect of which deduction has been claimed in the instant year. Two letters granting options to Shri Murali Krishnan K.N. and Neville Bain have been randomly filed which are dated 2nd April, 2002. If the options are granted on 2nd April, 2002, then 25% of the total option shall vest in the employees at the end of the first year from this date, which date would be 1st April, 2003. As such, the amount would become deductible in the previous year relevant to assessment year 2004-2005 and not 2003-2004. The ld. AR contended that though these letters are dated 2nd April, 2002, but in fact the options were granted on 1st April, 2002. The correct date of grant and vesting needs to be verified at the AO's end.

d. The ld. AR has stated that the amount of discount claimed as deduction in the earlier years in respect of unvesting/lapsing options has been reversed at the relevant time. There is no finding either in the assessment or the impugned order in this regard. This fact should also be verified by the AO to ensure that the overall expenditure booked by the company is restricted only to the extent of the exercised options.

12.3. The AO will decide the instant issue in the fresh proceedings as per our above directions on the legal question before this special bench and by considering, *inter alia*, the aforenoted case-specific factual scenario dealt with in para 12.2. above. Needless to say, the assessee, who will have liberty to lead any fresh evidence in its defence, will be allowed a reasonable opportunity of hearing.

13. Before parting with this matter we wish to place on record our deep appreciation for the illuminating arguments advanced by both the sides, which greatly assisted us in the disposal of the issue raised before the special bench. We also want to make it clear that all the cases relied on by both the sides have been duly taken into consideration while deciding the matter. The omission of reference to some of such cases in the order is either due to their irrelevance or to ease the order from the burden of the repetitive *ratio decidendi* laid down in such decisions.

14. Now the instant appeals are directed to be placed before the Division Bench for disposal having regard to the decision of the special bench on the questions raised before it.

Order pronounced on this 16th day of July 2013.