Taxation of Tomorrow Taxing Stock Appreciation Rights

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V | D H | Centre for Legal Policy

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A. Background

Evolution and transformation have been standout features of the 20th and the 21st century especially with regard to the functioning of businesses. Several factors including globalisation, digitisation, social transformation, and a worldwide health crisis have contributed to a paradigm shift in the way business is done, and transactions are structured. In contrast, legal frameworks responsible for governing and managing emerging trends have not evolved as rapidly. This has fueled concerns about the growing gap between the rate of economic and social growth *vis-à-vis* the management of such changes through legal mechanisms.

The absence of legal change as a response to changes in economic, social and personal domains may entail a variety of ramifications. For instance, the same may lead to legal uncertainty, it may result in the lack of inclusion leading to discrimination, and it may render certain statutes obsolete. Further, in tax statutes specifically, the lack of a change in law to adapt to changes in other domains may lead to the unintended creation of loopholes and lacunae, diluting the intent of the statute.

With the 'Taxation of Tomorrow' series, the Vidhi Centre for Legal Policy ('Vidhi' or 'we') aims to periodically reevaluate the Indian taxation framework to verify if it adequately meets the requirements of evolving business and commercial trends. Each report that forms a part of this series will identify a novel practice in the business sphere, study the legal background surrounding the same, identify inadequacies if any, and suggest reforms to address these inadequacies.

This report being the first in the series, starts with a topic that has been litigated several times, however the legal position regarding the same is still not entirely clear - stock appreciation rights. In today's emerging start-up environment, the demand for executive talent is high. However, start-ups are often cash strapped and cannot afford such talent. To counter these situations, various approaches have emerged which tie executive compensation to a company's value can offer effective tools for both enhancing company performance and attracting and retaining talent.

An example of such tools are Employee Stock Option Plans ('ESOPs'). ESOPs have been a common compensation tool for several decades and can be effective in attracting, retaining, and motivating employees to render the desired performance. However, it may cause the company to give up an unacceptable degree of control. Hence, start-ups are now moving towards what is known as 'stock appreciation rights ('SAR'), which may or may not involve the issuance of any actual equity, depending on the nature of the rights.

Since ESOPS have been around for a while, the taxation framework regarding the same has received a certain degree of certainty. As a relatively new tool for compensation, the tax framework surrounding SARs still need clarity despite several litigations on the issue. This report first establishes the concept of SARs and differentiates them from other more established tools for compensation and remuneration. It then analyses the international position with regard to taxation of SARs. Then we proceed to analyse the regulatory and taxation legal framework that govern SARs in India. The report subsequently analyses instances where the legal framework governing the levy of tax on SARs may be inadequate.

B. An Introduction to SAR

This chapter of the report provides an overview of the concept of SARs. It explores the types of SARs and also differentiates SARs from other compensation and remuneration schemes often employed by businesses.

1. An overview of SAR

SAR, also referred to as 'Equity Appreciation Right' is a scheme that entitles the participant to receive the monetary equivalent of the increase in the value of a specified number of shares over a specified period of time.[1] The date of payout of SARs may not be fixed, but may be any time after the SAR vests. One of the advantages of these schemes for businesses is their flexibility. Because of this the details of any plan are likely to differ from company to company.[2] Participants of SARs are typically employees, but may also include non-employee directors and independent contractors.[3]

SARs are normally paid out in cash ('Cash settled SARs'), but could be paid in shares ('Equity settled SARs') in certain limited circumstances. [4] In the case of *Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai*[5] Cash settled SARs were defined as "nothing but payment in cash to the excess of fair market value of common stock or other specified valuation of specified number of shares of common stock on the date the SAR was exercised over the fair market value of the common stock or other specified *valuation.*" On the other hand, equity settled SARs are described as a plan that gives the participant a right to receive securities.[6]

Illustrative example for SARs

Company A provides its employee Z 100 notional shares valued at INR 10 each in the year 2019, exercisable in the year 2021.

In the year 2021 when the price per share increases from INR 10 to INR 15, employee Z exercises her option to receive the appreciation in value over those 100 notional shares which is INR 500

*([Number of notional shares allotted*Market Value per Share at the Time of Exercise] – [Number of Notional Shares Allotted* Market Value per Share at the Time of Allotment]).*

Figure 1: An illustrative example of SARs

2. SARs in the broader context of incentive, rewards and compensation schemes

In order to mitigate managerial, financial, and operational difficulties, enterprises across the globe, large or small, unionized or not, public or private, growing or mature are developing innovative and flexible tools to pay compensation. This section of the report discusses some of the most common tools that are usually used to typically compensate employees.

[1] *Employment related Securities Manual, HMRC internal Manual, available at < https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm20195#:~:text=A%20stock%20appreciation%20right%20(SAR,a%20specified%20period%20of%20time.> last accessed on July 5, 2020.*

[2] *Employment related Securities Manual, HMRC internal Manual, available at < https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm20195#:~:text=A%20stock%20appreciation%20right%20(SAR,a%20specified%20period%20of%20time.> last accessed on July 5, 2020.*

[3] *Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai [2016] 70 taxmann.com 27 (Chennai - Trib.)*

[4] *Employment related Securities Manual, HMRC internal Manual, available at < https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm20195#:~:text=A%20stock%20appreciation%20right%20(SAR,a%20specified%20period%20of%20time.> last accessed on July 5, 2020.*

[5] *[2016] 70 taxmann.com 27 (Chennai - Trib.)*

[6] *Employment related Securities Manual, HMRC internal Manual, available at < https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm110025> last accessed on July 5, 2020.*

First, equity based incentives are popular tools to help retain, attract and motivate employees. Initially prevelant only in the territory of upper management and large companies, stock options have now become an increasingly popular method in recent years of rewarding middle management and other employees in both mature companies and start-ups. Employee stock-option programs give employees the right to buy a specified number of a company's shares at a fixed price.[7] Pursuant to the exercise of this option, the employees in question hold a stake in the company's total equity, and get proportionate rights of control. By virture of being actual shareholders, many recipients of ESOPS also have the right to make transactions with a third-party on the markets.

Second, restricted stock options are also rapidly gaining populatiry as a tool to incentivise employees. These schemes generally come with two constraints. The first relates to whether the employee stays with the company. In most cases, the restricted stock is forfeited if the employee terminates employment. The second relates to trading on the stock. Generally, restricted stock cannot be traded until the end of the restriction period.[8] This bucket would ideally include phantom stocks wherein the company deposits hypothetical shares in an employee's account. These shares become actual shares at the end of a specified period, if the employee remains with the firm.[9] These methods are considered beneficial for the company as they don't necessarily need to alter their ownership structure, or grant voting rights until the shares are actually vested in the employee in question. It also motivates the employee to be vested in the company's performance.

Third, deferred compensation as the name suggests, is a scheme through which companies defer the payments to a later date. These schemes could be in the form of back pay once the business reaches a profit.[10] A key advantage of deferred compensation plans is the opportunity for the company to minimise working capital issues. Often, future payments are linked to the price of the company's stock. This bucket would include phantom pure cash schemes or cash settled SARs wherein the plan mirrors a real share plan, but does not give the participants any right to acquire shares. Instead, the phantom scheme promise participants a cash sum calculated so as to equate to the increase in the value of notional tracker-shares between a starting date (to mirror the date when a real option would have been granted) and a date or period of time when they can claim the cash bonus (to mirror when a real option would have been exercised). The promise, like a real share award or option, is usually subject to performance conditions that have to be met. The employee obtains a cash employment reward by reference to the increase in the value of the business in the same way as if a real option had been exercised and real shares acquired.[11] There are many commercial reasons why an employer may use such a phantom scheme: for example the company's owners may be happy to share the economic value of equity, but not equity itself. Or the employer is a division of another company, but can create a measurement of its equity value and wants employees to have a share in that even though there is no actual stock.[12]

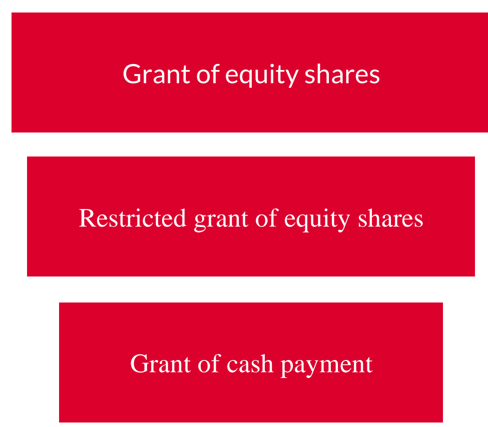

Figure 2: Rights under various schemes

Equity settled SARs discussed above where the participating employee is granted equity of an amount equivelant to the appreciation in the value of a specified number of shares over a specified period of time, would be covered under bucket two discussed above. These schemes do entail the actual grant of stocks at the expiry of the stipulated period. Cash settled SARs on the other hand would get covered under bucket three discussed above. In

[7] *Creativity and Innovation in Reawrd and Compensation Practices, Dr. Pallavi Pathan and Dr, Amitabh Pandey, available at <https://www.researchgate.net/publication/337196050_Creativity_and_Innovation_in_Reward_Compensation_Practices> last accessed on July 5, 2020.*

[8] *Employee Stock Options (ESOPs) and Restricted Stock: Valuation Effects and Consequences, Aswath Damodaran Stern School of Business, September 2005, available at < http://people.stern.nyu.edu/adamodar/pdfiles/papers/esops.pdf> last accessed on July 5, 2020.*

[9] *Employee Stock Options (ESOPs) and Restricted Stock: Valuation Effects and Consequences, Aswath Damodaran Stern School of Business, September 2005, available at < http://people.stern.nyu.edu/adamodar/pdfiles/papers/esops.pdf> last accessed on July 5, 2020.*

[10] *Creativity and Innovation in Reawrd and Compensation Practices, Dr. Pallavi Pathan and Dr, Amitabh Pandey, available at <https://www.researchgate.net/publication/337196050_Creativity_and_Innovation_in_Reward_Compensation_Practices> last accessed on July 5, 2020.*

[11] *Employment related Securities Manual, HMRC internal Manual, available at <https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm110020> last accessed on July 5, 2020.*

[12] *Employment related Securities Manual, HMRC internal Manual, available at <https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm110020> last accessed on July 5, 2020.*

such schemes, the general idea is typically that that computation of the cash payment made at the end of the temr is linked to the value of the company stock on the date of settlement.

As noted previously, these schemes are meant to be flexibile, thus the details of any plan are likely to differ from company to company.[13] The terms of each plan may also be flexible such that it may guarantee an employee the right to receive securities at the time of settlement, but may also allow the employee to substitute cash in place of security.[14] Therefore, the determination of whether a certain plan falls under the first bucket described in this section, ie. an equity based incentive; or under the second bucket, ie. restricted stock options; or under the third bucket, ie. deferred compensation would depend on the scheme of the plan in question, and also on the settlement option that the employee chooses at the time of expiry of the plan.

Notably, while this section of the report only deals with situations in which companies offer these schemes to employees, there are situations where in schemes structured in a similar manner are offered to non-employee directors and independent contractors.[15]

3. Deffered Compensation vis-à-vis Equity compensation

As can be seen from the above analysis, while the *first* and the *second* bucket result in the actual grant of equity to option holders, the *third* bucket does not involve any issuance of equity.

The nature of rights that these two types of compensation tools provide are radically different. For the *first* and the *second* bucket which involve actual issuance of equity, the option holder gets substantive legal rights such as voting at the Annual General Meetings of the Company[16], or receiving dividends post excercising their options[17]. The right holder can further sell this equity at a premium to what the fair market value had been at the time of exercise. As noted above, since equity compensation tools have been around for a while in India, the taxation framework regarding the same has received a certain degree of certainty. These rights are taxed twice. First, at the time of exercise—the difference between the fair market value of the options and the amount actually paid by the option holder is treated as a perquisite and added to the total income either as salary, or business income, or other income. Second, at the time of sale of equity—the difference between the sale price and the fair market value at the time of exercise is treated as a capital gain.

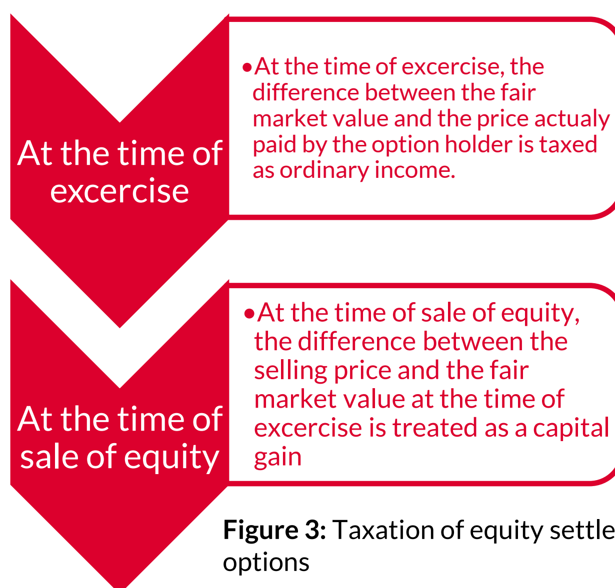

Figure 3: Taxation of equity settled options

[13] *Employment related Securities Manual, HMRC internal Manual, available at < https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm20195#:~:text=A%20stock%20appreciation%20right%20(SAR,a%20specified%20period%20of%20time.> last accessed on July 5, 2020.*

[14] *Employment related Securities Manual, HMRC internal Manual, available at <https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm110025> last accessed on July 5, 2020.*

[15] *Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai [2016] 70 taxmann.com 27 (Chennai - Trib.)*

[16] Section 47, Companies Act, 2013

[17] Section 51, Companies Act, 2013

On the other hand, for compensation tools in the *third* bucket which do not involve any issuance of equity, the option holder does not get any substantive rights that are associated with equity. All and any rights arising out of SARs are a creation of Contract as opposed to being a creation of statute. At the time of exercise, the option holder merely gets monetary compensation and there are no subsequent rights available to an option holder pursuant to the settlement of the option vide monetary payment unlike equity, which may be sold further. Hence, a tax treatment similar to what is applicable to the *first* and *second* bucket is not viable for the *third* bucket. As a relatively new tool for compensation in India, the tax framework surrounding SARs is still unclear, despite several litigations on the issue and hence needs to be addressed.

Figure 4: Taxation of compensation tools resulting in monetary compensation

C. An International Perspective

This chapter of the report provides an overview of the tax treatment of SARs in other parts of the globe. In the international markets, the treatment of SARs is largely consistent. There is no tax levied at the time of grant unlike ESOPs, and the employees are taxed when there is an actual cash payment made to the employees which forms part of their ordinary income.

1.1. The United States

In the United States, **Stock Appreciation Rights** are another method of compensating employees or independent contractors. A Stock Appreciation Right (SAR) is an arrangement, during a specified period, which the employee has the right to receive the increased value of the employer's stock by cashing out or exercising the SAR. The employee can only benefit from the appreciation in the value of the stock; therefore, a taxable event does not take place until the exercise of a SAR. The amount received upon exercise of the SAR is includible in the employee's income, constitutes wages, and creates a deduction to the employer at that time[18]. However, if the terms of the SAR limit the amount that an employee may receive upon exercise, the IRS has ruled income has been constructively received in the tax year in which the maximum limit has been attained[19]. In addition, an employee who fails to exercise a SAR has constructively received the value of stock at the end of its term[20].

However, the Tax Court in the United States dealt with a complex set of facts in a case[21] where an employee had received Phantom Stock options, but he died. His death triggered a 5 year countdown upon which the options would be redeemable. However, their spouse too passed away before she transferred the right to receive the benefit of phantom shares held by her to her heir. In ordinary circumstances, the final benefit would have been deemed as ordinary income if the original employee had received the actual cash payment. However, the Court ruled that the nature of a receipt changes in the hands of different people. While for the deceased employee, such income would have been in the nature of ordinary income, the transfer of such benefit to the wife and then her heir will be subjected to an estate tax at the value of the benefit at the time such transfers were made, and will be held by the heirs as a capital asset with the acquisition cost being equal to the value of the benefit at the time they are transferred to such heirs and subjected to an estate duty tax. Thus, at the time the benefits become redeemable by the second heir, they are subjected to a long term capital gains tax with the value of appreciation being the value of the benefit at the time it was transferred from the deceased person subtracted from the value of the final benefit received.

The above case highlights how the nature of the receipt may change in case SARs were to change hands from the employee who is originally slated to receive the benefit, to their legal heirs or any other third party. However, considering these plans are generally designed to be non-transferable, such tax treatment is only likely to arise if there is a succession issue involved, or if a secondary market for such instruments is appreciated and accepted in the corporate world.

[18] *Rev. Rul. 80-300, 1980-2 C.B. 165, Rev. Rul. 82-121, 1982-1 C.B. 79, and Treas. Reg. §1.451-2(a)*

[19] *Private Letter Ruling (PLR) 8104119*

[20] *Private Letter Ruling 8120103*

[21] *Hurford Investments No. 2, Ltd., No. 23017-11 (Tax Ct. 4/17/17)*

1.2. The United Kingdom

In the United Kingdom as well, the HMRC views such benefits as ordinary cash bonuses which are taxable when there is an actual payout made by the Companies[22]. As per Section 62 the Income Tax (Earnings and Pensions) Act 2003, these benefits when received form part of the employment earnings of such employees tax returns and are taxed accordingly.

1.3. Australia

In Australia as well, SARs are taxable upon exercise when the payment is actually received by such employees. While share based scheme are governed under the employees share scheme, schemes which result in a cash payout have been recognized specifically on the ATO's website as an instance of a bonus payment governed by Income Tax Ruling IT2534[23]. Under the said ruling, it is stated that income such as director fees, bonuses, etc are considered to have been derived for Income-tax purposes at the time such income is actually paid or otherwise made available to the employee. Further, the said ruling also states that such payments are only deductible by the employers in the tax year when such payment is actually made.

[22] *Employment related Securities Manual, HMRC internal Manual, available at <https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm20195>*

[23] *Taxation Ruling IT 2534 available at <https://www.ato.gov.au/law/view/document?LocID=%22ITR%2FIT2534%2FNAT%2FATO%22&PiT=99991231235958>*

D.The Legal Framework

This chapter of the report provides an overview of the regulatory and taxation framework applicable generally to incentive, rewards and compensation schemes, and specifically to SARs in India.

1. Regulatory framework

The Indian regulatory framework governing the aforementioned inventives, rewards and compensation schemes is different for listed and unlisted companies. For unlisted companies, while the Companies Act, 2013 has prescribed rules[24] for issuance of shares to employees under Stock Plans, it is silent on the grant and exercise of SARs including issuance of equity or cash settled SARs. The Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 ('SBEB Regulations') read with the Companies Act provisions[25] prescribe rules and regulations for formulation of Stock Plans and the grant and exercise of equity settled SARs by listed companies.

Notably, the Securities and Exchange Board of India ("SEBI") has, by way of its informal guidance, clarified that one of the criteria for determining the applicability of the SBEB Regulations to an employee benefit scheme is that such scheme should actually involve "dealing in, or subscribing to, or purchasing, securities of the company directly or indirectly".[26] SEBI has further stated that if the proposed scheme does not involve dealing in securities of the company, directly or indirectly, then the SBEB regulations are not applicable to the scheme, and thus held that cash-settled SARs are not governed by the SBEB regulations.

However, the definition of "Stock Appreciation Rights"[27] under the SBEB Regulations covers within its ambit, cash settled stock appreciation rights. Further, Regulation 1(3)(iii) provides that the SBEB Regulations are applicable to stock appreciation right schemes but does not provide a carve out for cash settled stock appreciation rights from its applicability. Thus, there still exists a conflict between the informal guidance issued by SEBI and Regulation 1(3) read with definition of "Stock Appreciation Rights" under the SBEB Regulations in so far as cash settled appreciation rights are concerned.

While under the SBEB Regulations, 2014, only employees and executive directors who are treated at par with employees of the Company under the Companies Act are eligible for receiving share based incentive schemes, however the cloud around the applicability of the scheme to cash-settled SARs as discussed hereinabove gives Companies the leeway to grant such rights to vendors and non-executive directors as well. Thus, until clarity is achieved in terms of applicability of rules and regulations with respect to cash-settled Stock Appreciation Rights, companies will have the liberty of formulating schemes for the grant and exercise of the such rights in a manner they may deem fit.

2. Taxation Framework

Under the Income Tax framework, there are several brackets under which income from SAR has been argued to fall, primarily depending upon whether the recipient is an employee, a non-employee director, or an independent

[24] Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014

[25] Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014

[26] Informal Guidance Note dated July 27, 2015 issued by SEBI in response to a request for informal guidance sought by Mindtree Limited in relation to (among others) the applicability of the SEBI Employee Benefit Regulation to a proposed Phantom Stock Scheme read with the Informal Guidance Note dated July 24, 2015 issued by SEBI in response to a request for informal guidance sought by Saregama India Limited

[27] Regulations 2(1)(ze) of the SBEB Regulations

contractor. This section of the report provides an overview of the existing framework that could potentially cover the issuance of SAR under the existing scheme of the Income Tax Act, 1961 ('IT Act').

2.1 Taxation of SAR income in the hands of employees

The Income-Tax Act ('IT Act') generally seeks to levy tax on 'prequisites' in lieu of, or in addition to any salary or wages.[28] The Supreme Court has held[29] that a core concept under the Income Tax Act is that a benefit/receipt under the Act must first be made taxable before it is regarded as Income, and that a receipt is not taxable as a perquisite in lieu of or in addition to salary or wages unless there is an enabling provision under Section 17(2).

Accordingly, Section 17(2) of the IT Act contains an exhaustive list of perquisites that an employee receives in their course of employment which are included in the head 'Salary' in their Income Tax Returns. It includes the value of benefits such as rent-free accommodation provided by an employer, the value of any concession in the matter of rent respecting any accommodation provided by an employer etc.

The present day sub-clause (vi) is relevant to benefits arising from the allotment of securities specifically. While the Revenue has tried to argue that the benefits arising from the allotment of securities are covered under sub-clause (iii), the Supreme Court[30] has specifically ruled that the provisions of sub-clause (iii) are not enough for the purposes of benefits arising from the allotment of specified securities to be qualified as perquisites under it.

The taxation of benefits arising from the allotment of securities has seen significant legislative changes. This section of the report outlines the evolution of the the respective provisions and the landmark judicial precedents in this regard.

2.1.1 Legislative History

Sub-clause (iiia) was inserted in clause (2) of the section 17 vide Finance Act, 1999, to include in the definition of 'perquisites' the value of any specified security allotted or transferred, directly or indirectly, by any person free of cost or at concessional rate to an individual who is or has been in employment of that person in the year of exercise of option of such shares. While the phrase 'securities' or 'specified securities' has never been defined under the Income-tax Act, the Securities Contract Regulation Act, 1956[31] defines 'securities' to include shares, scrips, bonds, debentures, debenture stock, derivative, units or any other instrument issued by any collective investment scheme, government securities, and rights or interests in securities etc. Interestingly, SARs do not fall within any of these definitions to be able to qualify as 'securities' under the Securities Contract Regulation Act, 1956. As noted above in the Regulatory Framework, even SEBI has by way of its informal guidance noted that the issuance of SAR is not an instance of "dealing in, or subscribing to, or purchasing, securities of the company directly or indirectly".[32]

Vide Finance Act, 2000, however, sub-clause (iiia) was removed and a proviso was inserted under sub-clause (iii) which made benefits arising from the allotment of shares, debentures or warrants directly or indirectly under any Employees' Stock Option Plan or Scheme of the company offered to such employees specifically exempt from tax. Thus, the value of any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants directly or indirectly under the Employees' Stock Option Plan or Scheme of the said company were not to be chargeable to tax from the assessment year 2001-02.

Vide Finance Act, 2001, the proviso to sub-clause (iii) was further amended to provide that there will be a perquisite value arising to the employees of the companies whose Employees' Stock Option Plan or Scheme of the company are not in accordance with the Central Government's guidelines[33]. Thus, instead of a blanket exemption proposed vide the Finance Act, 2000, only plans qualified under the Central Government's guidelines could avail the exemption. Since the said Guidelines provided for stock appreciation rights (SAR), an employee was

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[28] *Section 17, Income Tax Act, 1961.*

[29] *Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; MANU/SC/0495/2008*

[30] *Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; MANU/SC/0495/2008*

[31] *Section 2(h), Securities Contracts (Regulation) Act, 1956*

[32] *Informal Guidance Note dated July 27, 2015 issued by SEBI in response to a request for informal guidance sought by Mindtree Limited in relation to (among others) the applicability of the SEBI Employee Benefit Regulation to a proposed Phantom Stock Scheme read with the Informal Guidance Note dated July 24, 2015 issued by SEBI in r esponse to a request for informal guidance sought by Saregama India Limited*

[33] *Employees' Stock Option Plan Or Scheme; [SO 1021(E), DATED 11-10-2001]*

not taxable in relation to the benefits arising from SARs. There was also a departure from the phrase 'specified securities' as used in the erstwhile sub-clause (iiia) and SAR benefits were specifically excluded from the purview of taxation through the Central Government Guidelines[34]. Further, sub-clause (vi) was inserted which provided that the value of any fringe benefit or amenity provided to an employee shall be determined in such manner as may be prescribed. Thus, from the Assessment year 2001-02, until the introduction of fringe benefit tax in 2005, benefits arising from the allotment of securities and SARs remained largely outside the purview of taxation.

Subsequently, vide the Finance Act, 2005, benefits arising from 'specified securities' were brought within the purview of fringe benefits chargeable to tax under Chapter XII-H. Further, sub-clause (vi) was amended to provide that the value of any other fringe benefit or amenity which may be prescribed, shall exclude those fringe benefits which are chargeable to tax under Chapter XII-H. The proviso under sub-clause (iii) was removed vide the Finance Act, 2007, pursuant to the introduction of Fringe Benefit Tax for taxing such allotment of securities.

Vide Finance Act, 2009, the taxation of benefits arising from the allotment of 'specified securities' as perquisites was restored and the fringe benefit tax regime was discontinued. A new sub-cause (vi) was inserted to provide that perquisite include 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. However, the phrase 'specified securities' has still not been defined within the Act, nor are there any central government guidelines in place which specifically deal with SARs. As noted above, since SAR's do not fall within the ambit of 'securities' under the Securities Contract Regulation Act, nor are they defined as such under the Income-tax Act, the provisions of sub-clause (vi) may be insufficient to cover SARs within its ambit.

2.1.2 Important judicial pronouncements

Before delving into the cases specifically dealing with SARs, it is important to take not of the ruling in Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd.[35] which lays down certain important principles with respect to Section 17. In this case, the Supreme Court dealt with a situation where ESOPs had been granted by the employer to its employees without deducting tax at source prior to the introduction of sub-clause (iiia) vide the Finance Act, 1999. The Revenue argued that the difference between the fair market value, and the cost of allotment to the Employee should be regarded as a perquisite. However, the Court held that a core concept under the Income Tax Act is that a benefit/receipt under the Act must first be made taxable before it is regarded as Income. Even though an enabling provision had been inserted vide the Finance Act, 1999 vide clause (iiia) to sub-section (2) of Section 17, the Court held that a provision cannot be read retrospectively unless the legislature expressly provides for it. Further, the Court also held that the charging section and the computation provision together form an integral code. Since the mechanism for taxing ESOPs in the manner argued by the revenue was first introduced in 1999, the absence of a code earlier only signifies that such benefits were not taxable as perquisites. Accordingly, the Supreme Court held that without an enabling provision, it is not possible to tax the amount received by employees as perquisites, and hold the Company liable for not withholding tax. It is pertinent to mention that the current Section 17(2)(vi) only envisages a mechanism for computation of perquisites where securities are in fact allotted, and does not form an integral code for the purposes of SARs which do not actually involve any allotment of securities.

The taxability of SARs has seen a significant amount of litigation with different outomes. The question raised in these litigation have mainly been of two kinds.

First, whether the nature of the receipt in the hands of the employee at the time of pay-out is a capital receipt, or a perquisite under Section 17(2). Accordingly, the Courts have had varied opinions as to which head of income would the benefit arising from the payout of SAR's would fall into, depending upon the year of pay-out. While the revenue is inclined towards arguing for the taxability of SAR benefits as 'perquisites' under section 17, the assessees on the other hand have argued for the classification of such benefits as a capital receipt amenable to capital gains tax. The assessee's have argued for the classification of such benefits as a capital receipt because

[34] Employees' Stock Option Plan Or Scheme; [SO 1021(E), DATED 11-10-2001]

[35] Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; MANU/SC/0495/2008

there is usually no cost of acquisition[36] for the allotment of SAR benefits, and thus there is no capital gain that can accrue on SAR benefits such that they remain out of the purview of taxation.

Second, whether a receipt can be taxed as a 'perquisite' under section 17 in the absence of an empoyer- employee relationship. These cases have been discussed in detail in the foregoing paragraphs.

Whether the nature of the receipt in the hands of the employee at the time of pay-out is a capital receipt, or a perquisite under Section 17(2)?

Prior to the introduction of sub-clause (iiia)

In Sumit Bhattacharya vs. Assistant Commissioner of Income Tax[37], the ITAT dealt with the treatment of SAR benefits received prior to the year 1999. It was held that while the grant of SARs does not trigger any taxable event, the redemption of SARs is an employment related benefit, in the nature of deferred wages contingent upon financial performance of the ultimate employer i.e. parent company of the company with which the assessee has entered into employment contract, which is a purely monetary benefit. Further, it was also held that SARs which are a deferred monetary payment are substantially different in nature from stock option plans which result in allotment of shares and hence deserve a different tax treatment. While the ITAT was keen on classifying the benefit as perquisite under the head 'salary', however, being bound by the ruling in Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd.[38] which mandated that there must be a charging provision under Section 17 to regard the benefit under the head of salary, the said benefit was finally afforded the treatment of income under the head 'Other Sources'.

In the case of Addl. Commissioner of Income Tax v. Bharat V. Patel[39], the Supreme Court dealt with a similar situation. In this case however, the Court held that in the absence of an express statutory provision charging amounts received pursuant to exercise of such stock appreciation rights as perquisites, they are in the nature of a capital receipt and since no consideration is paid by the employee to receive these benefits, they remain out of the purview of taxation. Although in the instant case, the Supreme Court also opined that the said benefit will fall under Section 17(2)(iiia) of the Act which is akin to present days Section 17(2)(vi), and also deals with 'specified security', the Supreme Court did not allow for the retrospective application of the same considering the benefit in question was given before the insertion of sub-clause (iiia). However, this part of the decision only holds value to the extent of being an orbiter to the decision and SARs may still be left out of the purview of 'specified security' in a subsequent litigation for reasons illustrated above.

Post the introduction of sub-clause (vi)

In another case[40], which dealt with the treatment of SAR benefits received post the introduction of present days sub-clause (vi) of section 17(2), the assessees contended that SARs offered to them were a capital asset, therefore, the realization of the value of the SARs was nothing but capital gain . They further contended that since no security was offered or allotted to them, the SARs could not be construed as a perquisite. The tribunal held that the incentive was given to the assessees as a compensation for the services rendered to Cognizant Technologies India Pvt. Ltd. It was not given for transfer of capital asset or termination of any source of income. Therefore, the right conferred on the assessees, namely, Stock Appreciation Rights under the scheme cannot be construed as capital asset. What was conferred on the assessees is only valuation of appreciation for a specified number of stocks. The stock itself was not conferred on the assessees. The stock was retained in the common kit and the appreciation value was given to the assessees. Since the right to receive the appreciation value alone was conferred on the

[36] *Section 49 (2AA), Income-tax Act, 1961.*

[37] *Sumit Bhattacharya vs. Assistant Commissioner of Income Tax; MANU/IU/0001/2008*

[38] *Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; MANU/SC/0495/2008*

[39] *Addl. Commissioner of Income Tax v. Bharat V. Patel; AIR2018SC2681*

[40] *Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai; IT Appeal Nos. 209,335 & 390 (Mds.) of 2016; ([2016] 70 taxmann.com 27 (Chennai - Trib.))*

assessees and not right on the stock itself, the tribunal held that the amount received by the assessees was not a capital receipt and the same is liable for taxation as a revenue receipt.

whether a receipt can be taxed as a 'perquisite' under section 17 in the absence of an empoyer- employee relationship?

There may be instances wherein for the services rendered by an employee for a domestic company, the employee is granted SARs which are to be settled by way of cash for the foreign holding company. Interestingly, there is no employer-employee relationship between the foreign holding company and the receiver of such rights. Thus, it becomes important to identify the manner in which such benefit may be taxed in the hands of such employee.

In the case of Microsoft Corporation USA[41], the Authority for Advance Rulings ('AAR') held that the benefit arising to the employee of Indian subsidiary from stock option granted by its US parent company was taxable in the hands of Indian employee as 'salary'. The AAR, by lifting the corporate veil, held that 'the parent company has made such offer to the employees of the subsidiary company only because it regards its subsidiary and itself as the same concern'.

In another case[42], similar facts arose wherein the assessees were employees of Cognizant Technologies India, which was a subsidiary of CTS Corporation, a Delaware Corporation, USA (parent company of Cognizant USA). The Cognizant USA promoted an incentive plan to the employees of Cognizant India known as '1999 Incentive Compensation Plan'. As per this plan, an option was given to the employees of Cognizant Technologies India for providing cash settled SARs. Cognizant India deducted tax at source by treating the SARs as a perquisite in the hands of the assessees. SARs were also subjected to tax in USA since Cognizant USA also deducted tax on the same. The assessee contended that since they were not employees of Cognizant USA, the benefit could not be treated as a perquisite under Section 17.However, the Tribunal pierced the corporate veil to hold that the amount received by the assessee is a perquisite in the hands of the assessee and hence, the same has to be construed as income in the hands of the assessees. The tribunal further held that the incentive was given to the assessees as a compensation for the services rendered to Cognizant Technologies India Pvt. Ltd. , and since it was given in lieu of employment, the amount received shall be subjected to tax as a perquisite. The assessees had also contended that the value of Stock Appreciation Rights on realization suffered tax in USA. Therefore, while the tribunal confirmed that the value of Stock Appreciation Rights received by the assessees is liable for taxation, the matter was remitted back to the file of the Assessing Officer for limited purpose of examining whether the assessee had paid tax in USA on the value of the very same Stock Appreciation Rights in the light of the Double Taxation Avoidance Agreement between Government of India and Government of USA.

[41] *(P. No. 15 of 1998) [1999] 235 ITR 565 (AAR)*

[42] *Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai; IT Appeal Nos. 209,335 & 390 (Mds.) of 2016; ([2016] 70 taxmann.com 27 (Chennai - Trib.))*

2.1.3 Conclusion

As noted above, the provisions of the erstwhile clause (iiia) and clause (vi) were originally designed to cater to situations which involve an actual issuance of security to employees at a discounted rate. As per the orbiter in Addl. Commissioner of Income Tax v. Bharat V. Patel and the holding in Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax[43], sub-clause (iiia) and sub-clause (vi) of Section 17(2) are wide enough to cover within its ambit cash settled SAR's.

However, considering the ruling in Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd.[44] which mandates that there be an enabling code for a receipt to be taxable as a perquisite, and the subsequent ruling in Sumit Bhattacharya vs. Assistant Commissioner of Income Tax[45] which opines that the provisions of sub-clause (iiia) would not form a code for the purposes of cash settled SAR's, there still remains a cloud of doubt over the taxability of SAR benefits received by the employees. This doubt is further aggrevated owing to the regulatory framework which suggests that dealing in SAR is not an instance of dealing in securities.

Thus, it still remains unclear as to how cash-settled SAR's may be treated given the conflict between the tribunals and the Supreme Court, and SARs may be left out of the purview of 'specified security' in a subsequent litigation for reasons illustrated above. Nonetheless, the taxability of SAR benefits for different periods of exercise by the employees have been compiled hereinbelow.

Period of exercise of SARs	Taxability under the current framework (Y/N)	Relevant head of income
Prior to 2000	No	Capital receipt not chargable to tax
2000-2001	Uncertain	Unless specified securities are defined to include SARs, the issue remains contentious
2001-2002	No	Salary perquisite not chargable to tax
2002-2005	No	Salary perquisite not chargable to tax
2005-2009	Uncertain	Unless specified securities are defined to include SARs, the issue remains contentious
2009-present	Uncertain	Unless specified securities are defined to include SARs, the issue remains contentious

2.2 Taxation of SAR Income in the hands of non-executive/non-employee Director

As noted above in the regulatory framework, SAR's may also be awarded to a non-employe/non-executive Director. Under Section 2(24)(iv) of the Income-tax Act, any benefit or perquisite received by a director, whether convertible into money or not, is includible in the total income of such director. Accordingly, any benefit received by a non-employee director by virtue of SAR's is includible in the total income of such director, and the granting Company is required to deduct tax at source under Section 194j (ba) of the Income-tax Act under the ambit of 'professional fees' before making any remmitance.

[43] Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai; IT Appeal Nos. 209,335 & 390 (Mds.) of 2016; ([2016] 70 taxmann.com 27 (Chennai - Trib.))

[44] Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; MANU/SC/0495/2008

[45] Sumit Bhattacharya vs. Assistant Commissioner of Income Tax MANU/IU/0001/2008

While for employee directors, such income is includible under the head of Salary as perquisites in lieu of or in addition to salary. However, for a non-employee director, considering there is no employer-employee relationship, such income cannot form part of the salary income. Thus, for such non-employee directors, such benefits are charged to tax under section 56(2) (x) of the Income-tax Act under the head of 'income from other sources'.

2.3 Taxation as SAR Income in the hands of independent contractors

The IT Act also seeks to tax perquisites arising from business or the exercise of a profession.[46] The IT Act as it stands today only defines the expression 'perquisities' when received in lieu of or in addition to any salary or wages.[47] The scope of the term in light of business or profession has not been specifically addressed under the IT Act. However, case laws suggest that share based benefits received by an assessee are includible in their income under the head of 'income from business and profession' as perquisites under Section 28(iv) of the Income-tax Act.

In the cases of Bharat V Patel[48]and Sumit Bhattacharya[49], the Courts had opined that had the assesses concerned been involved in any business or profession by virtue of which SAR benefits had been derived, such income would have been includible in such assesses total income under the head of 'income from business or profession'. Furthermore, in Commissioner of Income-tax v. Ashish P. Deora[50], the Bombay High Court held that for income to fall under section 28(iv) , it is necessary that the benefit is derived by virtue of the business or profession of the assessee, and that the benefit is in-fact derived. In case the benefit is conditional and the assessee fails to comply and the benefit fails to accrue, no income can be included under Section 28(iv) of the Act.

Thus, for independent contractors, benefits derived from cah-settled SAR's are includible in the total income of the assessee under the head 'income from business and profession' under Section 28(iv) of the Income-tax Act.

[46] *Section 2(24(vd) and section 28(iv), Income Tax Act, 1961.*

[47] *Section 17, Income Tax Act, 1961.*

[48] *Commissioner of Income Tax v. Bharat V. Patel ; AIR2018SC2681*

[49] *Sumit Bhattacharya vs. Assistant Commissioner of Income Tax; MANU/IU/0001/2008*

[50] *Commissioner of Income-tax v. Ashish P. Deora; [2016] 73 taxmann.com 259 (Bombay)*

E. Recommendation

As noted from the above analysis, there exists a cloud of doubt surrounding the taxability of SAR income in the hands of employees. This in turn is likely to lead to unnecessary litigation. To avoid this, the Indian Revenue Authority should consider issuing a clarification in this regard to put the matter to rest.