Taxsutra Eye Share - Understanding the Taxability of SARs...

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Stock Appreciation Rights- Are they really taxable?

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 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.

An introduction to Stock Appreciation Rights

Stock appreciation rights is a scheme that entitles an employee to receive the monetary equivalent of the increase in the value of a specified number of shares over a specified period of time. The date of payout of SARs may not be fixed, but may be any time after the SAR vests. In the case of Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai[1] 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.

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

Figure 1: An illustrative example of SARs

SARs different from ESOPs

The nature of rights that these two types of compensation tools provide are radically different. Under an ESOP scheme which involves actual issuance of equity, the option holder gets 2 types of quantifiable benefits. First, at the time of exercise, the participant receives a discount on the equity's prevailing market price. Subsequently, the right holder can further sell this equity at a premium to what the fair market value had been at the time of exercise. By virtue of owning actual equity, the option holder also gets substantive legal rights such as voting at the Annual General Meetings of the Company[2], or receiving dividends, post exercising their options[3].

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 under the head of salary. 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.

On the other hand, a SAR scheme does not involve any issuance of equity. The option holder is entitled only to receive monetary compensation and there are no subsequent rights available to an option holder, unlike equity. Hence, a tax treatment similar to what is applicable to ESOPs is not viable for SARs. 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.

Taxation of SAR income in the hands of employees

The taxability of the amount received by employees from the exercise of SARs has always been under dispute vis-à-vis taxability as perquisite under head 'salary' or taxability as income under the head 'other sources' or taxability as income under head 'capital gain'.

The Income-Tax Act ('IT Act') generally seeks to levy tax on 'prequisites' in lieu of, or in addition to any salary or wages.[4] The Supreme Court has held[5] 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. Hence, 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).

The present day sub-clause (vi) of Section 17(2) is relevant to benefits arising from the allotment of securities specifically. The taxation of benefits arising from the allotment of securities has seen significant legislative changes. Sub-clause (iiia) was first inserted in clause (2) of 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[6] 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. 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".[7]

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.

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[8]. 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 stock appreciation rights were identified specifically as a qualified plan under the said Guidelines, an employee was not taxable in relation to the benefits arising from SARs.

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 which prevailed from 2005-2009 was discontinued. A new sub-cause (vi) akin to the erstwhile sub-clause (iiia) 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.

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. [9] 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. 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 Courts too 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 there is usually no cost of acquisition[10] 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.

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 [11], 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. [12] 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 [13], 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[14], 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 their employer. It was not given for transfer of capital asset or termination of any source of income. 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 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.

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[15], 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. [16] 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 [17] 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 aggravated 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.

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
2001-2005	No	Salary perquisite not chargable to tax
2005-2009[18]	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

For an in-depth analysis of Stock appreciation rights and the tax issues surrounding them, please refer to this report by the Vidhi Centre for Legal Policy titled 'Understanding Stock Appreciation Rights (SARs) as a Tool for Compensation and Remuneration'.

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[1] [2016] (Chennai - Trib.) [TS-252-ITAT-2016(CHNY)]

[2] Section 47, Companies Act, 2013

[3] Section 51, Companies Act, 2013

[4] Section 17, Income Tax Act, 1961.

[5] Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; [TS-62-SC-2008-O]

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

[7] 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

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

[9] Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; [TS-62-SC-2008-O]

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

[11] Sumit Bhattacharya vs. Assistant Commissioner of Income Tax; [TS-5001-ITAT-2008(MUMBAI)-O]

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

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

[14] Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai; IT Appeal Nos. 209,335 & 390 (Mds.) of 2016; ([2016] (Chennai - Trib.)) [TS-252-ITAT-2016(CHNY)]

[15] Soundarrajan Parthasarathy v. Deputy Commissioner of Income-tax, Chennai; IT Appeal Nos. 209,335 & 390 (Mds.) of 2016; ([2016] (Chennai - Trib.)) [TS-252-ITAT-2016(CHNY)]

[16] Commissioner of Income Tax, Bangalore vs. Infosys Technologies Ltd; [TS-62-SC-2008-O]

[17] Sumit Bhattacharya vs. Assistant Commissioner of Income Tax [TS-5001-ITAT-2008(MUMBAI)-O]

[18] The benefits arising from the allotment of specified securities were taxable as Fringe benefits Tax during the intervening period.