

P. No. 15 of 1998

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Court : Authority for Advance Rulings

Decided On : Nov-18-1998

Reported in : (1999)235ITR565AAR

Judge : S C Sen, S C Jain, M Bhussry

Appellant : P. No. 15 of 1998

Judgement :

Suhas C. Sen, J. (Chairman), Subhash C. Jain and Mohini Bhussry, Members
Bentley (H.M. Inspector of Taxes) v. Evans, [1959] 39 TC 132 (Ch D.); Abbott v. Philbin (Inspector of Taxes), [1960] 2 All ER 763 (HL); State of Uttar Pradesh v. Renusagar Power Co., 1. The applicant is a company incorporated in the USA. They set up another company in India, which is a fully owned subsidiary of the American company. The American company has made a proposal to enter into a stock option agreement with the employees of the Indian subsidiary. Under this agreement, the employees of the Indian company shall have the option to subscribe to the shares of the US company at a pre-determined price called the option price which will be lower than the ruling market price of the shares. The employees will have the option to subscribe and become the owners of the shares on any date of their choice. As and when such option is exercised, the employee will have to sell the shares in the open market in the USA at the ruling stock market price. The net gain is to be repatriated to India through the banking channels. The purpose of this stock option plan is stated to be- to attract and retain the best available personnel for positions of substantial responsibility, to

provide additional incentive to such individuals, and to promote the success of the company's business by aligning employees with financial interests with long-term shareholder value. The questions on which advance ruling is sought are as under :

"1. Whether money received by the employees of its Indian subsidiary, by exercise of stock option granted to them constitutes income from salaries 2. Whether tax has to be deducted under Section 192 of the Income-tax Act, 1961, by the applicant-company on the amount earned by the employees of subsidiary from exercise of stock option granted to them by applicant company ?" 2. The sum and substance of the scheme is that an employee of the Indian company by exercising the option to subscribe will be able to get shares in the parent company (the American company) and immediately sell the same at the ruling market rate in U. S. A. If this scheme was evolved by the Indian company, this would have constituted an additional remuneration to the employees. The only difficulty is that the stock option is being offered not by the employer, the Indian company but by the American company which is the parent company of the Indian company. The position in law of such an offer for the purpose of income-tax was examined in the case of Bentley (H. M. Inspector of Taxes) v. Evans [1959] 39 TC 132 (Ch D.). In that case, the employees of a Canadian company and its subsidiaries were offered shares in the parent company at a price 15 per cent, below the then market price.

Under the terms of the offer, the purchase price of the shares was payable by instalments, which were recoverable by deductions from pay.

At the end of any month in which the parent company had received sufficient funds to pay the purchase price, the company was to issue the shares and deliver the share certificate to the employee.

Thereafter, an employee was free to dispose of any shares which had been fully paid up and issued to him.

3. In that case and also in the case of Abbott v. Philbin (Inspector of Taxes) [1960] 2 All ER 763 (HL) the question was at which point of time the income was to be taxed in the hands of the employee. That the amount will be taxed under Schedule E of the English Income Tax Act was not in dispute. Schedule E tax was leviable in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom for

the year of assessment. In the case of Bentley (H. M. Inspector of Taxes) v. Evans [1959] 39 TC 132 (Ch D) Roxburgh J. observed (at page 140) : "If the respondent had been in the employment of the parent company, I should have held without hesitation that it was additional remuneration but as he was not it appears to me that it must be a perquisite or other profit". Roxburgh J. observed (page 140) : "what did happen was that he got the shares, all 15 of them, at the price which he was required to pay for them, but that price was reduced by reason of the fact that he was an employee of the subsidiary company, and, therefore, the perquisite or other profit which he made was the difference between the figure of the market price either on September 30, 1953, or October 7, 1953 (and I have not been asked to decide that question) and the price which he bound himself to pay as a condition of getting the shares." 4. The difference between Bentley's case [1959] 39 TC 132 (Ch D) and the case before us is that in Bentley, the employee was at liberty to sell the shares as and when he liked after getting them at a discounted value of 15 per cent, from the parent company. In the case before us, the employee of the Indian company has no such option. The shares will be issued and sold immediately thereafter.

5. In the case of Abbott v. Philbin (Inspector of Taxes) [1960] 2 All ER 763 (HL), the offer was made by a company to its employees giving them an option to purchase shares of the company at less than market price. This offer was given not only to the executives of the company but also of its subsidiaries. The appellant was secretary of the company and was also given this option. He exercised this option on March 20, 1956, when 250 shares were allotted to him. He subsequently sold the shares in the year 1955-56 and made profit which was brought to tax under Schedule E. There was no dispute that the amount was assessable under Schedule E, but the dispute was in respect of the year of assessment.

6. The Crown's case was that the shares, which were allotted to the employee, were ultimately sold. The employee became liable to pay tax in that year in which profit was made by such sale. The assessee's case was that the option was the perquisite and he was liable to be assessed for the year 1954-55 in respect of the value of the option when it was granted minus the price he paid for it.

7. Viscount Simonds, with whom the majority of the judges agreed, held thus (page 366) : "In my opinion, the Crown cannot succeed in this essential aspect of the case unless it is established as a general proposition that an option to acquire shares at a fixed price in such circumstances as those of the present case is not a perquisite of office. It must be shown that, even if at the date of the option being granted the market price is higher than the option price, the option is not a perquisite which falls within the Schedule, This appears to me an impossible proposition. What distinguishes such a right from that commonly given to a shareholder in a commercial company, when, upon an issue of shares, he is given in the form of a provisional allotment letter the right to take up new shares at a certain price He can exercise his right and take up the shares, or he can sell his right to do so, or he can do neither and let the offer go by default. But, from the moment he has the letter, he has a right of more or less value according to the circumstances. So, too, the grantee of such an option as that which we are considering has a right which is of its nature valuable and can be turned to pecuniary account. He has something at once assessable to tax".

8. Lord Keith in his dissenting judgment summed up the issue in that case in the following words (page 382) : "It is common ground here that there has been a profit of the employment, and the only question is whether that profit is to be extracted from grant of the option per se or from the exercise of the option. On either view, it is impossible to relate the profit to any year other than the year of receipt." 9. Lord Denning also differed with the majority view and held that mere receipt of the option was not taxable. He observed (page 384) : "the expectation of receiving a benefit, no matter how well founded, is not itself a perquisite or profit. It must be reduced into possession. A bird in the hand is taxable, but a bird in the bush is not".

10. In the case before us it is nobody's case that mere receipt of the option was perquisite and taxable in the year in which the offer was received. Since the shares were to be issued and sold simultaneously, it is common ground that the amount will be taxable only when the option was exercised. If the option was never exercised, there would be no profit nor any accrual of benefit because the right of stock option given to the employees could not be transferred.

11. Therefore, the taxability of the amount to be gained by exercise of the option cannot be in doubt. It is a perquisite or profit arising out of employment. The only question is whether the amount will be taxable under the head "salary". In this connection, it has to be noted that "perquisite" and "salary" have been specifically defined in India. The scope and effect of these definitions will have to be examined. What is a perquisite under English law, may not be so under our law.

"15. Salaries.--The following income shall be chargeable to income-tax under the head 'Salaries'-- (a) any salary due from an employer or a former employer to an assessee in the previous year, whether paid or not ; (b) any salary paid or allowed to him in the previous year by or on behalf of an employer or a former employer though not due or before it became due to him ; (c) any arrears of salary paid or allowed to him in the previous year by or on behalf of an employer or a former employer, if not charged to income-tax for any earlier previous year".

(iv) any fees, commissions, perquisites or profits in lieu of or in addition to any salary or wages ; (va) any payment received by an employee in respect of any period of leave not availed of by him ; (vi) the annual accretion to the balance at the credit of an employee participating in a recognised provident fund, to the extent to which it is chargeable to tax under Rule 6 of Part A of the Fourth Schedule ; and (vii) the aggregate of all sums that are comprised in the transferred balance as referred to in Sub-rule (2) of Rule 11 of Part A of the Fourth Schedule of an employee participating in a recognised provident fund, to the extent to which it is chargeable to tax under Sub-rule (4) thereof." 13. Sections 15 and 17 are couched in very broad terms. But, however broad the language may be, unless the relationship of employer and employee exists between the payer and the payee, the amount received by the payee cannot be taxed as salary. The amount may be profit or gain arising out of employment but if the payer is not the employer or the payment is not being made for and on behalf of the employer, the amount cannot be brought to tax as salary but will have to be brought to tax as income from other sources under Section 56. This, in short, is the case of the applicant.

14. This argument, however, overlooks that salary includes perquisites or profits in lieu of or in addition to any salary or wages under Section 17(1)(iv).

15. The expression "perquisite" has been defined in Clause (2) of Section 17 as under : (i) the value of rent-free accommodation provided to the assessee by his employer ; (ii) the value of any concession in the matter of rent respecting any accommodation provided to the assessee by his employer ; (iii) the value of any benefit or amenity granted or provided free of cost or at concessional rate in any of the following cases : (b) by a company to an employee being a person who has a substantial interest in the company ; (c) by any employer (including a company) to an employee to whom the provisions of paragraphs (a) and (b) of this sub-clause do not apply and whose income under the head 'Salaries', (whether due from, or paid or allowed by, one or more employers), exclusive of the value of all benefits or amenities not provided for by way of monetary payment, exceeds twenty-four thousand rupees ; Explanation.--For the removal of doubts, it is hereby declared that the use of any vehicle provided by a company or an employer for journey by the assessee from his residence to his office or other place of work, or from such office or place to his residence, shall not be regarded as a benefit or amenity granted or provided to him free of cost or at concessional rate for the purposes of this sub-clause ; (iv) any sum paid by the employer in respect of any obligation which, but for such payment, would have been payable by the assessee ; and (v) any sum payable by the employer, whether directly or through a fund, other than a recognised provident fund or any approved superannuation fund or a Deposit-linked Insurance Fund established under Section 3G of the Coal Mines Provident Fund and Miscellaneous Provisions Act, 1948 (46 of 1948), or, as the case may be, Section 6C of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (19 of 1952), to effect an assurance on the life of the assessee or to effect a contract for an annuity :".

16. Therefore, any benefit or amenity received by the employee including the benefit of purchase of shares of the American company at a concessional rate will have to be treated as perquisite under Section 17(2)(iii).

17. But then such perquisite will have to be given by the employer as laid down in the given definition.

18. If the definition of salary as given in Sections 15 and 17 is examined, it will be seen that any salary paid by an employer to an employee as well as salary paid "by or on behalf of an employer or a former employer" have been brought within the ambit of "salary" chargeable to tax under Section 15. In this case, stock option is being given to the employees of the Indian company. It is true that the American parent company is making this offer. This is with a view to give an incentive to employees of the Indian company. There would have been no problem had the stock option been offered by the Indian company. But the position in law will not be different only because the stock option is offered not by the Indian company but by its parent company. If the "salary" is paid for or on behalf of the employer that will also have to be included in the "salary" income by virtue of Clause (b) of Section 15.

19. In this case, stock option has been offered to the employees of the Indian company. If and when the option is exercised by the employee, shares will be allotted and thereafter sold. The resultant profit will be taxable in the hands of the employee. The amount that the employee will receive will come to him in addition to the salary which the employee will get from the Indian company. It is something more than what is due to him under the contract of employment. Therefore, this additional amount will clearly come within Section 15(b) of the Income-tax Act. The stock option scheme has been devised to enable an employee to get additional remuneration. Roxburgh J., in the case of *Bentley v. Evans* [1959] 39 TC 132 (Ch D), held that such payment should be held without hesitation as additional remuneration. In that case, as the stock option was offered by the parent company, the benefit of the option enjoyed by the shareholder was held to be perquisite or other profit. However, the law in India is different. Because of the express provisions of the Act, there is no difficulty in holding that the benefit to be given to the employees will be additional remuneration.

Salary has been defined in Section 17(iv) to include, inter alia, perquisites or profits in lieu of or in addition to any salary or wages. The employees, in this case, are going to receive something in addition to their salary and wages. The stock option scheme will enable them to get something in addition to their remuneration. This addition will clearly come within the definition of the expression "salary".

Whether it is paid by the employer or by somebody else for or on behalf of the employer will not make any difference. This has been made clear by Clause (b) of Section 15.

20. The next question is whether the amount is paid for or on behalf of the employer. To answer this question, we have to bear in mind that the offer is being made to the employees of the Indian company which is a fully owned subsidiary. Its business is completely controlled by the parent company. The object of making such offer can only be the desire to give a benefit to the employees and at the same time, to enhance their interest in the company. The parent company has made such an offer to the employees of the subsidiary company only because it regards its subsidiary and itself as the same concern. It wants to reward and encourage the employees of the subsidiary company. Even if the subsidiary is treated as a separate juristic entity, the stock option offered by the American company must be treated to have been made for and on behalf of the Indian company. Otherwise, there is no reason why an independent and altogether separate American company will try to give encouragement to the employee of an Indian company. It is the employer's job to look after its employees by paying salary and giving other benefits. If some other company pays additional benefits to the employees, then it must be held to have been done for and on behalf of the employer.

21. Moreover, in a case like this the corporate veil will have to be lifted to see the real nature of the transaction. The only possible explanation for the offer of stock options by the American company to the employees of the Indian company can be that it regards its business and the business of the Indian company as one. There is no difficulty in law in recognising the reality of the transaction and treating the benefit to be given to the Indian employees as one by the employer himself or by the American company for or on behalf of the employer. In either view of the matter, this additional remuneration or profit will have to be treated as income from "salary". The Supreme Court in the case of *State of U. P. v. Renusagar Power Co.* [1991] 70 Comp Cas 127, observed that the doctrine of lifting the corporate veil was expanding in the context of modern jurisprudence. The court held on the facts of that case that "the holding company and the subsidiary were to be treated as

one and the same because the subsidiary was created to generate and supply energy and power to the holding company in order to enable it to maintain its production commitments to the State and therefore generation of power was considered for the purposes of excise to be the holding company's own source of supply and not supply from a separate company." 22. In the instant case, the American company has floated an Indian subsidiary. It has devised a scheme to give encouragement and pecuniary incentive to the employees of the Indian company by offering to them an option to purchase its own shares at a pre-determined price. This sort of transaction is not possible unless the parent company treats its own business and the business of the Indian company as one.

23. There is yet another aspect of the case. In the case of Bentley v. Evans [1959] 39 TC 132 (Ch D) Roxburgh J., held that an option to buy shares given by a Canadian company to the employees of its English subsidiary will be "perquisite or other profit" and taxable as such under Schedule E. Perquisite or any other profit of employment will clearly come within the ambit of the definition of the expression "salary" given in Section 17(1). Moreover, "perquisite" has also been broadly defined in Section 17(2) and will include the value of any benefit or amenity provided at a concessional rate.

24. The next question is whether, there should be a deduction of tax at source by the American company in respect of the income arising on account of stock option. The gain made by an employee after exercise of the stock option may be taxable as salary. The American company has taken upon itself the responsibility of paying this salary. The provision of Section 192 of the Income-tax Act will be clearly attracted. It will have to deduct tax at source before payment of any salary to the employees of the subsidiary company.

25. By devising the stock option scheme, the American company has taken upon itself the responsibility for paying, what must be regarded as "salary" to the employees of the Indian company. They are under obligation under Section 192 to deduct income-tax at source on the amount payable to the employees.

26. We, therefore, answer both the questions in the affirmative and in favour of the Revenue.

