

**IN THE INCOME TAX APPELLATE TRIBUNAL
“A” BENCH : BANGALORE**

BEFORE SHRI GEORGE GEORGE K., JUDICIAL MEMBER
AND
Ms. PADMAVATHY S, ACCOUNTANT MEMBER

IT(TP)A No.2395/Bang/2019
Assessment year: 2015-16

Northern Operating Services Pvt. Ltd., 2 nd Floor, RMZ Ecospace, Campus 1C, Sarjapur Outer Ring Road, Bellandur Village, Varthur Hobli, Bengaluru – 560 103. PAN:AACCN 1652J	Vs.	The Joint Commissioner of Income Tax, Special Range 5, Bengaluru.
ASSEESSEE		RESPONDENT

Assessee by	:	S/Shri K.R. Vasudevan & Ankur Pai, Advocates
Respondent by	:	Shri K. N. Suresh Babu, Jt.CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	25.01.2023
Date of Pronouncement	:	31.01.2023

ORDER

Per Padmavathy S., Accountant Member

This appeal is against the final assessment order passed u/s. 143(3) r.w.s. 144C(13) of the Income-tax Act, 1961 [the Act] dated 26.9.2019 by the JCIT, Special Range 5, Bangalore, for the assessment year 2015-16.

2. The assessee is a company engaged in the business of providing back office services in the nature of processing of securities, banking operational activities, administrative services, etc. to its AE. The assessee filed the original return of income for the AY 2015-16 on

25.11.2015 declaring total income of Rs.81,25,92,790. The case was selected for scrutiny and the notice u/s. 143(2) was duly served on the assessee. Since the assessee had international transactions with its AE, a reference was made to the TPO to arrive at the arm's length price (ALP) of the international transactions. The TPO arrived at a TP adjustment of Rs.36,79,45,675. The AO passed a draft assessment order and besides the TP adjustment, the AO made an adjustment towards Employee Stock Option Plan [ESOP] for an amount of Rs.1,41,47,125. Aggrieved, the assessee raised objections before the DRP whereby the TP adjustment was reduced to Rs.21,29,68,370 and the ESOP disallowance was sustained. Accordingly, the AO passed the final assessment order against which the assessee is in appeal before the Tribunal.

3. The assessee vide letter dated 3.1.2023 withdrew the grounds relating to TP adjustment pursuant to Mutual Agreement Procedure (MAP) Resolution acceptance by the Competent Authority, copies of which are placed on record. Accordingly, grounds No.1 to 20 raised with regard to TP adjustment are dismissed as withdrawn.

Disallowance of ESOP expenses

4. The assessee is contending the disallowance of ESOP expenses through ground Nos.21 to 27 which read as follows:-

“Erroneous disallowance of Payment of Employee Stock Option Plan (ESOP) expenses

21. The Hon'ble DRP / learned AO has erred in disallowing ESOP expenses, amounting to INR 14,147,125, by contending that the same is a fictitious cost.
22. The Hon'ble DRP / learned AO has erred in holding the loss on account of discounted price of shares is only a notional / imaginary loss and not a crystallized one.
23. The Hon'ble DRP erred in issuing the directions, without appreciating the directions issued in the case of the Assessee for AY 2012-13 wherein, it has held that if the Assessee has considered the said ESOP as perquisite at the time of vesting and has deducted taxes on the same, the said ESOP expenditure should be allowed as deduction.
24. The Hon'ble DRP / learned AO has erred in disallowing Stock Options expenses without appreciating the fact that the same is taxable in the hands of employees, as 'Perquisites' under the head "Salary", at the time of exercise of options and not at the time of vesting of options.
25. The Hon'ble DRP / learned AO ought to have appreciated that as per the provisions of section 17(2)(iv) of the Act to be read with Rule 3(8) of the Income tax Rules, 1962 , stock options are taxed in the year of exercise of options. However, in the instant case, the ESOPs have not been exercised by the employees till FY 2015-16.
26. The Hon'ble DRP / learned AO has erred in disallowing expenses on Restricted Stock Units ('RSU') without considering the details submitted by the Assessee that the tax has been deducted on the 'Perquisite' amount as "Salary" income, at the time of vesting of the RSU.
27. Notwithstanding and without prejudice to our above contention, if the ESOP expenses are not considered as allowable expenditure for the subject AY, the learned AO should allow expense to the Assessee in the year in which the employees will exercise the options.”
5. The brief facts in this regard are that that the assessee had participated in the Northern Trust Corporation 2012 Stock Plan issued by its parent, The Northern Trust Company (“NT Corporation”)

whereby awards based in shares of the NT Corporation were granted directly by 'The Compensation and Benefit Committee' of NT Corporation's board of directors to the Assessee's employees through the stock option ("ESOP") scheme or the restricted stock unit ("RSU") scheme. Under the ESOP scheme, stock options on equity shares of the ultimate holding company i.e., NT Corporation were granted to the employees and Directors of the ultimate holding company, its subsidiaries and affiliates. The equity shares are granted directly by the ultimate holding company to the employee. Accordingly, employees are eligible to participate in the scheme and option is given to the employees to purchase defined number of shares at concessional price by way of exercising the options. The ESOP expenses represents the discount offered to Assessee's employees on issue of shares of its ultimate holding company i.e., NT Corporation, being the difference between the fair market value of shares on the date of grant and the exercise price. The said expense was initially incurred by NT Corporation and was subsequently reimbursed by the assessee to NT Corporation. **A sample copy of the debit note raised by NT Corporation on the assessee is available at page 159 of paper book.** The assessee claimed the amount reimbursed to NT Corporation as an expenditure in the statement of profit and loss as 'Employee Benefit Expense'. Further, RSU's were also issued by NT Corporation to the employees of the assessee as a part of employee compensation scheme. Under this scheme, the employee received cash payments, based on the fair market value, on completion of vesting period. Further, the cost of

such expense (being the fair market value *less* exercise price) was apportioned over the vesting period in the books of account of the Assessee. The that assessee has included such value of RSU in the salary of the employee as “perquisite” and deducted the applicable taxes on the same. **The sample copies of Form 16 issued to the employees are available at page 160 to 174 of paper book.** The assessee claimed expenses of Rs.1,41,47,125/- towards Employee share-based payments while filing the return of income for the year under consideration.

6. The AO in the draft assessment order proposed to disallow the amount of Rs.1,41,47,125/- claimed by the assessee towards Employee share-based payment expenses. The AO proposed to disallow the expenses for the following reasons:

- There was no transaction that resulted in loss. The loss on discounted price of share was only an imaginary loss (notional) and not a crystallized one.
- The said expenditure was notional, contingent in nature and not allowable under section 37 of the Income-tax Act, 1961 (“Act”).
- The judicial precedents relied on by the assessee were not accepted since the Department had filed appeal against the same before the Higher Appellate Authorities i.e., High Court.
- The AO relied on the decision of the Hon’ble High Court of Karnataka (“KHC”) in the case of *Infosys Limited* and held that no perquisite arises in the hand of an employee till the shares have been actually to them.
- The Employee share-based expenses booked by the assessee and reimbursed to its holding company was a ‘colourable devise’ to shift profits outside India.

7. Aggrieved, the assessee filed its objections before the DRP. The DRP rejected the objections of the assessee with respect to the Employee share-based payment. The DRP relying on Delhi ITAT in the case of *ACIT v Ranbaxy Laboratories ITA No.2613 and 3871/2004* upheld the disallowance made by the AO and held as under:

- The perquisite was charged to the employees on mere amortization of the expenses though option had not been exercised by the employees as on the charge of perquisite. The assessee cannot claim ESOP as allowable deduction prior to the date of exercise of option by the employee.
- The issue of shares was not crystallized till the date on which the employee exercises the option and hence, any expenditure debited during the vesting period remains contingent in nature.
- The assessee was choosing to either receive securities premium of a lower amount or no securities premium when compared to that of which it would have received during a normal course of share issue. There was therefore no expenditure that the Assessee was incurring or laying out.
- The ESOP expense even if treated as expenditure was a capital expenditure, securities premium being a capital item.
- Expenditure on ESOP recharge was a fictitious cost being discount offered on self-generated asset.
- Expenditure that was debited was only notional loss to the holding company.
- Expense booked by the assessee and reimbursed to the holding company was a colourable device for shifting profits from India.

8. The Id. AR submitted that ESOP form parts of the employee's compensation as 'perquisite. It was further submitted as follows:-

- The primary objective of ESOP is to earn profit by securing consistent and concentrated efforts of dedicated employees during the vesting period.
- The said expenses represent the incentives provided to employees who stay with the assessee over a longer period of time and therefore, is in the nature of 'employee compensation'.
- ESOP is taxable in the hands of the employees as 'perquisites' under section 17(2) of the Act. In the case of ESOP's, the perquisites are considered when the employee has exercised the option and in the case of RSU, when the employee receives cash payments on completion of vesting period.
- Accordingly, there cannot be different treatment for a transaction in the hands of recipient of income and payer of income. Given that the ESOP forms part of an employee's salary, it supports the claim for the same being treated as revenue expenditure in the hands of the employer.

ESOP expenses is not notional/ contingent in nature and allowable under section 37 of the Act

As per the provisions of section 37 of the Act, an expenditure to be deductible under section 37 of the Act, the following conditions should be satisfied:

- There should be an expenditure
- Such expenditure should not be governed by section 30 to 36 of the Act
- The expenditure should not be capital in nature
- The expenditure should not be personal in nature
- The expenditure should have been laid out wholly and exclusively for the purpose of business

It was submitted that ESOP expenditure is not in the nature of capital expense or personal expense and the same is not in the nature of fine or

penalty. Discount on ESOP representing amount foregone on shares to be issued to employees in lieu of services rendered by them qualifies as 'expenditure' under section 37 of the Act. The ESOP expenditure incurred by assessee is not a contingent liability. In this regard, the Assessee submits as under:

- The discount on options under ESOP is an ascertained liability and not contingent liability. Further, as mentioned above, NT Corporation has raised a debit note on the assessee in relation to the same and there is actual outflow of funds to NT Corporation.
- The ESOP expenditure represents discount on issue of shares. The quantum of expenditure depends on the number of employees accepting the offer. However, the same does not render the expenditure contingent.
- It is a settled principle that the deduction is permissible in respect of an ascertained liability. The provision, which is scientifically or actuarially ascertained, is construed as an accrued liability and deduction will be allowed on the same.
- Further, what should be certain is the incurring of the liability and it should also be capable of being estimated with reasonable certainty, though the actual quantification may not be possible. If the said requirements are satisfied the liability is not a contingent one.
- The AO has not raised any point of contention against the expense being wholly and exclusively for the purpose of business and has only contended that it is notional in nature and also that it is on capital account.

9. In view of the above, the Id. AR submitted that ESOP expenditure is an ascertained liability and accordingly, the same should be allowed under section 37 of the Act.

10. The Id. DR relied on the orders of lower authorities.

11. We heard the rival submissions and perused the material on record. We notice that the coordinate bench of the Tribunal in the case of *Novo Nordisk India P. Ltd. v. DCIT*, [2014] 42 taxmann.com 168 (Bang. ITAT) has considered the similar issue and held that –

18. We have considered the rival submissions. It is clear from the facts on record that there was an actual issue of shares of the parent company by the assessee to its employees. The difference, between the fair market value of the shares of the parent company on the date of issue of shares and the price at which those shares were issued by the assessee to its employees, was reimbursed by the assessee to its parent company. This sum so reimbursed was claimed as expenditure in the profit & loss account of the assessee as an employee cost. The law by now is well settled by the decision of the Special Bench of the ITAT Bangalore in the case of *Biocon Ltd. v. Dy. CIT* [2013] 35 taxmann.com 335 and other connected appeals, by order dated 16.07.2013, wherein it was held that expenditure on account of ESOP is a revenue expenditure and had to be allowed as deduction while computing income. The Special Bench held that 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.

19. In the present case, there is no dispute that the liability has accrued to the assessee during the previous year. The only question to be decided is as to whether it is the expenditure of the assessee or that of the parent company. We are of the view that the observations of the CIT(A) in para 5.6 of his order that these expenses are the expenses of the foreign parent company is without any basis and lie in the realm of surmises. The foreign parent company has a policy of offering ESOP to its employees to attract the best talent as its work force. In pursuance of this policy of the foreign parent company, allowed its subsidiaries/affiliates across the world to issue its shares to the employees. As far as the assessee in the present case which is an affiliate of the foreign parent company is concerned, the shares were in fact acquired by the assessee from the

parent company and there was an actual outflow of cash from the assessee to the foreign parent company. The price at which shares were issued to the employees was paid by the employee to the Assessee who in turn paid it to the parent company. The difference between the fair market value of the shares of the price at which shares were issued to the employees was met by the Assessee. This factual position is not disputed at any stage by the revenue. In such circumstances, we do not see any basis on which it could be said that the expenditure in question was a capital expenditure of the foreign parent company. As far as the assessee is concerned, the difference between the fair market value of the shares of the parent company and the price at which those shares were issued to its employees in India was paid to the employee and was an employee cost which is a revenue expenditure incurred for the purpose of the business of the company and had to be allowed as deduction. There is no reason why this expenditure should not be considered as expenditure wholly and exclusively incurred for the purpose of business of the assessee.

20. We fail to see any basis for the observation of the CIT(A) that the obligation to issue shares at a discounted price to the employees of the Assessee was that of the foreign parent company and not that of the Assessee. Admittedly, the shares were issued to employees of the Assessee and it is the Assessee who has to bear the difference in cost of the shares. The expenditure is necessary for the Assessee to retain a health work force. Business expediency required that the Assessee incur such costs. The parent company will be benefitted indirectly by such a motivated work force. This will be no ground to deny the deduction of a legitimate business expenditure to the Assessee as laid down by the Hon'ble Supreme Court in the case of Sassoon J. David & Co. (P.) Ltd. (supra).

21. The reference by the CIT(A) to the provisions of Sec.40A(2)(b) of the Act is again without any basis. The price of the shares of NNAS is arrived at by applying the average market price for the period 3rd October, - 17th October, 2005 in the Copenhagen Stock Exchange. The price so arrived at and the price at which shares are issued to the employees of the Assessee is the benefit which the employees get under the ESOP. The Assessee or its parent company can never influence the stock market prices on a particular date. There is no evidence or even a suggestion made by the CIT(A) in his order. There is no basis to apply the provisions of Sec.40A(2)(b) of the Act.

22. With regard to the decision of the ITAT in the case of AccentureServices (P.) Ltd. (supra), we find that the facts of the case of Accenture Services (P.) Ltd. (supra) are identical. In the case of Accenture Services (P.) Ltd. (supra), the facts were that the assessee company incurred certain expenses on account of payments made by it for the shares allotted to its employees in connection with the ESPP. The AO had disallowed Rs. 9,06,788/- incurred by the assessee on the ground that this expenditure is not the expenditure of assessee company but that expenditure is of parent company and the benefit of such expenditure accrues to the parent company and not assessee. The CIT(A) deleted the addition made by the AO. The CIT(A) found that the common shares of Accenture Ltd. the parent company, have been allotted to the employees of ASPL, the Indian affiliate/Assessee and not to the employees of the parent company. The CIT(A) also found that though the shares of the parent company have been allotted, the same have been given to the employees of the Assessee at the behest of the SUNIL Assessee. The CIT(A) thus held that it was an expense incurred by the assessee to retain, motivate and award its employees for their hard work and is akin to the salary costs of the assessee. The same was therefore business expenditure and should be allowable in computing the taxable income of the assessee. The tribunal upheld the view of the CIT(A). It can be seen from the decision in the case of Accenture Services (P.) Ltd. (supra) that the shares of the foreign company were allotted and given to the employees of affiliate in India at the behest of the affiliate in India. The CIT(Appeals), however, presumed that the facts in the instant case of the assessee was that the shares were allotted to the employees of the affiliate in India at the behest of the foreign company. This is not the factual position in the assessee's case, as the assessee had on its own framed the NNIPL ESOP Scheme, 2005, to benefit its employees. NNAS may have a global policy of rewarding employees of affiliates with its shares being given at a discount and that policy might be the basis for the Assessee to frame ESOP. That by itself will not mean that the ESOP was at the behest of the parent company. In any event the immediate beneficiary is the Assessee though the parent company may also be indirect beneficiary of a motivated work force of a subsidiary. We are of the view that the factual basis on which the CIT(Appeals) distinguished the decision of the Mumbai Bench of ITAT in the case of Accenture Services (P.) Ltd. (supra) is erroneous.

23. With regard to the observations of the CIT(Appeals) that the ESOP actually benefits only the parent company, we are of the view that the expenditure in question is wholly and exclusively for the purpose of the business of the assessee and the fact that the parent company is also benefited by reason of a motivated work force would be no ground to deny the claim of the assessee for deduction, which otherwise satisfies all the conditions referred to in section 37(1) of the Act. The decision of the Hon'ble Supreme Court in the case of Sassoon J. David & Co. (P)Ltd. (supra) and the Hon'ble Karnataka High Court decision in the case of Mysore Kirloskar Ltd. (supra) clearly support the plea of the assessee in this regard.

24. We are of the view that in the facts and circumstances of the present case, the expenditure in question was wholly and exclusively for the purpose of the business of the assessee and had to be allowed as deduction as a revenue expenditure.

25. For the reasons given above, we direct the expenditure be allowed as deduction.

12. The assessee's case being identical, respectfully following the above decision of the coordinate Bench, we hold that the expenditure towards ESOP is eligible for deduction u/s 37 of the Act.

13. In the result, the appeal by the assessee is allowed.

Pronounced in the open court on this 31st day of January, 2023.

Sd/-

(GEORGE GEORGE K.)
JUDICIAL MEMBER

Sd/-

(PADMAVATHY S)
ACCOUNTANT MEMBER

Bangalore,
Dated, the 31st January, 2023.

/Desai S Murthy /

Copy to:

1. Assessee
2. Respondent
3. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.

By order

Assistant Registrar
ITAT, Bangalore.