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PRE-BUDGET MEMORANDUM OF REPRESENTATIONS 2022 – 2023 : PERSONAL TAX

Sl. No	Section/Subject	Issue	Rationale with factual data	Recommendation
1	**Valuation of Company Owned Accommodation provided to employees under section 17(2) of the Act**	As per the current Income Tax Law read with the Income Tax Rules, the taxable value of rent free accommodation (company owned – 'VRFQ') provided to employees is taken @ 15% of "Salary" in cities having population exceeding 25 lakhs. In other cases, it is taxable @ 10% of salary in cities having population between 10 lakhs and 25 lakhs and 7.5% of salary in other places. In case of leased / rented accommodation, value of the accommodation is taken at the stipulated percentages or lease rent, whichever is lower. The definition of 'Salary' includes Basic, Bonus, Commission and all other taxable allowances excluding DA & Perquisites. With increase in 'Salary' due to career growth & inflation, the taxable value of VRFQ increases significantly year on year even though the employee may be staying in the same company provided accommodation. This increases the tax burden on the employees significantly over the years and acts as a demotivating factor.	The above method of determination of the perquisite suffers from various inequities. For example, for the same employee staying in the same company owned accommodation, the perquisite will increase with any salary increase. Again, for the same company owned accommodation, different employees with different salaries will have different perquisite value. Also, irrespective of the size/quality of company owned accommodation, the perquisite for a particular employee will be determined as a percentage of salary. A detailed note on the anomalies in taxing this perquisite along with the suggested methodology that can be adopted by amending the relevant Income Tax Rule is enclosed as **Annexure 1.**	It is suggested that in case of company owned accommodation the concept of fair value should be introduced to ensure that the right amount of perquisite is determined for income tax purposes. Fair Value should be defined as the comparable rent in the location concerned – suggestion in this regard is captured in Annexure 1.

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2	**Taxation for Individuals**	(a) Tax rates : Consequent to the reduction of corporate tax rates, the differential between personal and corporate tax o has widened. The highest marginal rate for individuals has now gone up to 42.74% (highest slab) against the normal Corporate Tax Rate of 25.17%.	The high personal tax rate for individuals in India stands out as an exceptionally high rate as compared to other countries. For example, Hongkong – 15%, Sri Lanka – 15%, Bangladesh – 25% &Singapore – 22%. Further, the huge gap in the tax rates as mentioned between individual and corporate tax ratesis leading toseveral structuring decisions being adopted in favour of corporate model (for example, proprietorship business moving to company format).	It has become an urgent necessity to reduce the personal tax rates for individuals so that there is a degree of equity and fairness in relation to structuring decisions as well as being competitive with other countries.
		(b) Budget 2020 has ushered in an important change in terms of income tax regimes. There is a new tax regime that coexists with the old one.	With two tax regimes in place, income tax for individuals have become very complicated. Further, there are different rates of taxes depending upon the source of income. In addition to this, different rates of surcharge are applicable depending upon the total income and capital gains element in the total income both under the old and new tax regime. Under the new tax regime u/s 115BAC of the Act, wherein lower slab rates have been prescribed, the benefit of standard deduction has been taken away. The objective of providing standard deduction is that it allows salaried individuals to claim a flat deduction from income towards expenses that would be incurred with relation to his or her employment. Therefore, there is no rationale for not providing this deduction to the assessees opting for the tax rates prescribed u/s 115BAC of the Act.	It is suggested that the tax structure for individuals be simplified. This will also help in improving the compliance. Further, the standard deduction should be restored for employees opting the tax rates prescribed u/s 115BAC of the Act.

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3	**Taxing of ESOPs in the hands of the employees**	The current Income Tax Law, provides for taxation of ESOPs as a 'perquisite' under section 17(2) of the Act, consequent to the abolition of Fringe Benefit Tax (FBT). The section states that ESOPs issued free of cost or at concessional rates will be taxed on the date of exercise on the difference between the "*fair market value*" and the amount actually paid by the employee. The "*fair market value*" is to be determined based on stipulated methods which have been separately prescribed by the CBDT.	This methodology of taxation suffers from following drawbacks: (a) It seeks to tax a notional benefit at a time when the actual gain is not realised by the employee. In fact, it is possible that the actual sale of shares could result in a loss for the employee. Since the perquisite tax paid earlier cannot be set off against the capital loss, the employee suffers a double loss, namely tax outgo and loss on sale of shares. (b) The question whether the ESOPs are granted at a concessional rate is being determined with reference to the "*fair market value*" on the date of exercise of the options. Technically, this is an incorrect approach. If the ESOPs are issued at the prevailing market price on the date of grant, the issue should be treated as "*non concessional*". This would be in line with the guidelines issued by SEBI. Any subsequent gain accruing to the employee due to favourable market movements by the date of vesting or exercise of option cannot be treated as a "*perquisite*" granted by the employer. (c) Due to the above approach of treating ESOP as perquisites at the time of 'vesting', a peculiar situation may arise where the share price post exercise goes down below the grant price. In such a situation, the employees would have suffered 'perquisite tax' at the time of exercise and still suffer a loss since the share price has subsequently declined. This is a double whammy adversely impacting the morale of the employees and goes against the concept of ESOPs as an incentive offered by employers to retain talent. (d) Further, if such subsequent gains are a perquisite in the hands of employees, it would stand to reason that the value equivalent of	It is suggested that the taxation of ESOPs as perquisite at the time of allotment / exercise should be removed for the reasons explained in the Rationale column. If at all, **ESOP should be taxed at the time of exercise based on the fair market price prevailing on the date of grant.** Any subsequent appreciation should only be taxed at the time of realization / sale by the employees concerned under the head "Capital Gains". Govt. of India has recently shifted the point of incidence of taxation of ESOPs for start-ups. Such a relaxation should be extended to ESOPs issued by all employer companies.

			such a perquisite should have been a deductible expenditure in the hands of the company issuing the ESOP. Since the tax law does not contemplate such a deduction, the taxation of the perquisite would result in double taxation.	
Sl. No.	**Section/Subject**	**Issue**	**Rationale with factual data**	**Recommendation**
	Taxing of ESOPs in the hands of the employees***….contd. from previous page***		(e) Also, from the strictly legal angle, there are a number of differences between ordinary shares and ESOP shares. Therefore, they are not comparable. The taxation principles currently existing, result in discrimination. The market value is also strictly not applicable since there are lock-in periods applicable. A detailed note on these aspects is enclosed (**Annexure 2).** (f) Since the actual sale of shares will attract capital gains tax, if applicable, it is unnecessary to subject the employee to perquisite tax. In fact, before FBT was imposed on ESOPs, specific provisions existed in the Income Tax Act for exempting the same from perquisites and subjecting it only to capital gains tax. (g) It may be noted that ESOPs have emerged over the years as a critical, motivational and retention tool for companies in a highly competitive market for talent. It is a very effective instrument for encouraging employees to perform and excel and is a win-win proposition for the employers / shareholders on one hand and the employees on the other. Hence, a uniform & fair methodology of taxing ESOPs would go a long way in encouraging the Corporate sector in nurturing & retaining human capital.	

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4	**Taxing of Employer's Contribution to Recognized Provident Fund and Superannuation Fund beyond Rs.7.5 lakhs u/s 17(2)(vii) of the Act and interest / income earned / accrued thereon u/s 17(2)(viia) of the Act.**	The Finance Act, 2020 had imposed tax on employees in respect of the Employer's Contribution to Recognized Provident Fund and Superannuation Fund in excess of Rs.7.5 lacsalong with the accretion by way of interest, dividend etc. pertaining to the said excess. The methodology prescribed for computing the said perquisite value is complicated and it is impossible for an employer to determine the correct perquisite value for the said contribution to PF & SAF beyond Rs.7.5 lakhs, prior to close of a financial year. At best, employers have to an estimate for completing their salary processing and TDS obligation u/s 192 of the Act and only in the subsequent year they can determine the actual earnings attributable to the said contribution more than Rs.7.5 lakhs per annum. Added to this complexity is the expectation that income should be compounded year on year and included in the perquisite value.	It may be noted that there are various types of Superannuation Funds. In case of the new pension scheme and similar superannuation funds, the contributions made by the employer vests with the employee and he can transfer it from one employer to another. However, in other cases, contributions made by the employer to a Superannuation Fund do not accrue to the benefit of the employee till such time he retires upon superannuation, when the Fund is used to purchase annuities and/or to pay the commuted pension to the retired employee. Such contributions may or may not result in superannuation benefits to the employees since there are various conditions to be fulfilled by the employees like serving a stipulated number of years, reaching a certain age etc. Therefore, this should not be taxed as perquisite as per the ratio of decision laid down by the Hon'ble Supreme Court in **CIT vs. L W Russel [2002-TIOL-686-SC-IT]**.Since the pension payments are subjected to tax at the time of actual receipt by the employee concerned post retirement, he is ending up paying tax twice on the same amount – once as a perquisite on accrual and again as pension at the time of receipt. Further, the methodology prescribed for determining perquisite value of income / interest earned or accrued on the said contribution over Rs.7.5 lakhs is very complicated and cannot determine the actual income prior to the close of a financial year for an employer to consider as perquisite and include the said amount for determining TDS u/s 192 of the Act.	To avoid double taxation of the same amount, it is recommended that the said contribution in excess of Rs.7.5 lacs as per section 17(2)(vii)of the Act should not be taxed as perquisite. Without prejudice to the above, if the decision is to continue taxing such excess PF/SAF contribution, then at least the interest / income earned or accrued thereon should be left out of the perquisite tax net.

Sl. No.	Section/Subject	Issue	Rationale with factual data	Recommendation
5	**Deduction for Personal Tax Computation**	The Finance (No.2) Act, 2014 had increased the overall limit to Rs.1.5 lac in respect of deduction under section 80C of the Act	Need to increase the standard deduction limit from Rs.1.5 lakhs that was fixed way back in 2014. With higher inflation, there is a need to revise the said ceiling u/s 80C of the Act to Rs.2.5 lakhs. This would act as a fillip to investments and also generate greater savings for the tax payer.	It is recommended that this limit be increased to at least Rs.2.5 lac.
Sl. No.	**Section/Subject**	**Issue**	**Rationale with factual data**	**Recommendation**
6	**Medical Reimbursements for Retired Employees (for hospitalization)**	Under section 17 of the Act, medical reimbursements received by employees from employers are not taxable in respect of expenditure incurred in approved hospitals and for prescribed diseases. Further, specific tax relief is also provided to employees in respect of medical treatment outside India for self and family. However, such tax benefits are not available to retired employees.		It is suggested that the provisions of section 17 of the Act r/w relevant rules be amended to include retired employees as well for the tax benefit on medical reimbursements/hospitalization expenditure, both for domestic and foreign medical treatment.
7	**Leave Travel Concession/Assistance– tax relief every year and replacement of calendar year by financial year**	As per the current provisions, Leave Travel Concession/Assistance is eligible for tax relief for 2 calendar years in a block of 4 calendar years.		It is suggested that the concept of calendar year should be replaced with financial year (April – March) in line with the other provisions of the Income Tax Law. Moreover, the concerned tax relief should be granted annually and be extended to both domestic and foreign travel, to give a fillip to the Travel and Tourism Industry.

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8	Exemption from tax for payment of Leave Encashment to be raised to Rs.10 lakhs	The exemption limit for payment of leave encashment is notified by the CBDT in accordance with the powers given under section 10(10AA) of the Act. The current limit of Rs. 3 lakhs is very old (since 1998) and needs to be raised substantially with immediate effect.	The ceiling u/s 10(10AA) of the Act was fixed way back in 1998. There is an urgent to revise this figure upwards considering inflation and other factors.	It is suggested that the limit of exempted amount of leave encashment should be raised at least to Rs.10 lakhs.
Sl. No.	**Section/Subject**	**Issue**	**Rationale with factual data**	**Recommendation**
9	**Tax concessions to Senior Citizens**	The population in the current senior citizens' category did not have a robust social security / pension fund investment facility during their working life. As a result, they are hugely dependent on interest income from fixed deposits etc. The rate of interest has come down drastically in the past one year leaving the senior citizens in financial difficulty. Further, actual inflation is much higher than headline inflation numbers. This has added to their misery. Additionally, medical expenses shoot up heavily in the old age. Persons covered by Mediclaim insurance policies have to cough up very high insurance premia	For the reasons captured under the 'Issues' column, It is recommended that beneficial tax measures should be introduced for senior citizens in the upcoming budget.	Minimum tax exemption limit for senior citizens (60 years age to 80 years age) should be increased to Rs. 7.5 lakh from the current threshold of Rs. 3 lakh. Very Senior Citizens who are aged above 80 years should be exempt from tax if their income is up to Rs. 12.5 lakh. There should not be any TDS from payment of interest to Senior and Very Senior Citizens. Ceiling for Health Insurance premium along with deduction for medical expenses for senior citizens as per the provisions of section 80D of the Act should be removed.

		after one or two claims. There should not be any TDS from payment of interest to Senior and Very Senior Citizens. Currently, the health insurance premium for a senior citizen is eligible for deduction to the extent of Rs 50,000.		

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10	**Contribution to National Pension Scheme (NPS)**	At present the voluntary contribution of Rs 50,000 is allowed as a deduction u/s 80CCD(1B) of the Act	Govt. of India should encourage contribution to NPS by even private sector employees, since it would provide a social security net during old age of such employees. Hence, it is recommended that the quantum of deduction u/s 80CCD of the Act should be increased for private sector employees to incentivize them contribute to NPS.	The deduction u/s 80CCD(1B) amount should be increased to Rs 1,50,000/-. Further, In case of employees of private companies who subscribe to NPS, 15% of the salary should be allowed as deduction u/s 80CCD(1) and 80CCD(2) of the Act, instead of 10%.

11	**Rationalization of tax rate for income of dividend earned by residents**	With the abolition of Dividend Distribution Tax (DDT) by Finance Act 2020, dividend is now taxed in the hands of shareholders at applicable slab rate. The payer is required to withhold taxes from dividend prior to making payment. Accordingly, resident shareholders are liable to pay tax on the dividend income, which could be as high as 35.88% (inclusive of the maximum surcharge capped at 15%). However, in case of non- resident shareholders section 115A of the Act provides for taxation @ 20%. Further, a non - resident shareholder may also be eligible to avail benefits under a tax treaty, where tax rate may be much lower, generally in the range of 10%-15%.	Dividend are declared out of tax paid profits. Therefore, levy of further tax on dividend received by the shareholderleads to double taxation of the same income. Hence, a concessional rate of 10% (or any other suitable rate) may be considered along with a basic exemption upto Rs. 1 lakh. This would also remove disparity in the taxation of dividend, between resident highnet-worth individuals (HNIs) and non-resident shareholders. Reduction in the base rate of tax on dividends in the hands of resident shareholders will encourage citizens to invest in the Stock Markets which would lead to broader financial inclusion and provide attractive source of fund raise to promoters. This would, in turn, lead to capital investments by the private sector, which is what the Govt. of India has been nudging them to do, especially during Covid times when the Govt. is looking to raise funds to invest in infrastructure and employment generating initiatives.	Similar to the reduction in surcharge on dividends to 15%, even the base rate of tax on Dividend Income should be brought down from the current 30% to 10% in respect of resident shareholders.

Annexure 1

PERQUISITE VALUATION UNDER SECTION 17(2) OF THE INCOME TAX ACT, 1961 IN REPSECT OF COMPANY OWNED ACCOMODATION PROVIDED TO EMPLOYEES

Background

As per Section 17(2) of the Income Tax Act, 1961, “Perquisite” includes value of rent-free accommodation provided to an assessee by his employer. The methodology for computing the perquisite value as stipulated in the Act is tabulated below:

Basis of Valuation of Perquisite – Rent Free Accomodation

Population of City As per 2001 Census	Where accommodation is owner by Employer	Where Accommodation is taken on Lease by Employer
Exceeding 25 lakhs Exceeding 10 Lakhs but below 25 lakhs Any other	15% of Salary 10% of Salary 7.5% of Salary	Lease Rent paid or payable by Employer (or) 15% of Salary, whichever is lower (*less*) rent, if any paid by the employee.

*‘**Salary**’ for the above purpose includes: Pay, Allowances, Bonus or Commission or any other monetary payment but does not include DA, Employer’s contribution to PF, allowances exempt from tax and value of perquisites*.

Issues

The aforementioned method of determination of perquisite value in respect of company owned accommodation suffers from various inequities, as summarised below:
1) Firstly, the perquisite value and the consequent tax implication on a company owned accommodation is NOT linked to the rental value of the said property; instead it is linked to the Salary earned by the employee, which is not a fair benchmark to determine the perquisite value of such accommodation.

2) Secondly, the perquisite value in case of company owned accommodation is significantly more than on an accommodation taken on lease by an Employer. Reason being, in case of a leased accommodation, as per Rule 3(1) – Table I: Clause (2)(b) of the Income Tax Rules, perquisite value represents “*actual amount of lease rent paid or payable by the employer or 15% of salary, whichever is lower as reduced by rent, if any, actually paid by the employee”.*

In other words, in case of leased accommodation, perquisite value is linked to lease rent paid or payable, which would be invariably lower than 15% of Salary and so employees staying in leased accommodation would suffer lower perquisite tax on this count. Whereas, in case of accommodation owned by employers, the perquisite valuation is determined basis only 'Salary' without any linkage to the fair rental value of such property.

3) Thirdly, where the salary of employees increases (considering inflation, performance of the company, employee etc.) equally, in respect of the employee staying in the same company owned accommodation, the perquisite value and related tax implication will be much more as compared to another employee staying in a similar accommodation taken on lease by the employer – again due to the linkage of perquisite valuation of company owned accommodation to the Salary and NOT to the fair rental value of such property.

4) Fourthly, it may be noted that, neither the employer offers nor the employee seeks to change the accommodation provided to him/her frequently or every time his/her Salary is increased. So, increase in perquisite valuation of such accommodation & related tax impact happens mechanically, without any correlation to the quality/size of accommodation provided to employees - where the accommodation is owned by the employer.

5) And the tax impact becomes worse if the Salary of an employee staying in company owned accommodation crosses the slab of Rs.2 crores or Rs. 5 crores, since it would attract higher surcharge1 – **this increase in tax rate would have adverse impact on his/her total post tax income, resulting in a situation where his/her take home salary after tax could be even lower than another employee, despite getting a performance rating superior to that of another employee.**

6) Further, for a similar company owned accommodation, employees with different salaries will have different perquisite value. To clarify, assuming the Employer owns 2 similar flats in a residential complex offered to two of its employees, the tax implication would be adverse for the employee whose salary is more than the other one – again due to the linkage of perquisite value to the Salary than to the fair rental value of accommodation.

From the above analysis, it can be appreciated, **irrespective of the size or quality of company owned accommodation, the perquisite value and the consequent tax implication on the employees staying in company owned accommodation, increases significantly every year, since under the present law, it is getting determined as a percentage of salary, without any correlation to the fair rental value of the said accommodation**.

7) Definition of ‘Salary’ for Rent Free Accommodation significantly different from that for House Rent Allowance**:**

It is pertinent to note that since the basis for computation of perquisite value u/s 17(2) is ‘Salary’, the definition of what constitutes ‘Salary’ is of paramount importance.

i) Section 17(1) read with Explanation 3 to Section 17(2)(ii) defines ‘Salary’ for the purpose of computing the perquisite value of rent-free accommodation. *‘**Salary**’ for the above purpose includes: Pay, Allowances, Bonus or Commission or any other monetary payment but does not include DA, Employer’s contribution to PF, allowances exempt from tax and value of perquisites.* Consequently, the base figure on which perquisite value is determined is an all-inclusive figure due to which the aforementioned inequities arise.

ii) On the other hand, ‘Salary’ for the purpose of determining the taxable value of House Rent Allowance (**HRA**) granted by an employer to an employee u/s 10(13)A of the Income Tax Act read with Rule 2A of the Income Tax Rules is defined as follows --

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1 *While, base tax rate is 30%, surcharge varies from 10% for Income between Rs.50 L – 1 cr; 15% for Rs.1 cr – 2 cr, 25% for Rs.2 cr – 5 cr and 37% for Income above Rs.5 crores. So, marginal tax rate, including Cess @ 4%, moves from 31.2% to 34.32% to 35.88%, 39% with the highest being 42.744%.*

Salary" shall have the meaning assigned to it in clause (h) of rule 2 of Part A of the Fourth Schedule"

And, 'Salary' under Fourth Schedule: Part A - Rule 2(h) to Income Tax Act reads,

"Salary" includes Dearness Allowance, if the terms of employment so provide, but excludes all other allowances and perquisites.

It may be noted that there is a significant variance in the definition of 'Salary' for the purpose of computing perquisite value of rent-free accommodation of private sector employees Vs. the definition of 'Salary' for determining taxable HRA – which is the fundamental cause for inequity in taxation of private sector employees.

Implications

1) Retention of skilled manpower is a critical requirement for a company to be successful on a sustainable basis. One of the motivating tools adopted by corporates is to provide a good quality residential accommodation (typically owned & maintained by corporates) and related facilities to its employees & their families. However, the perquisite valuation methodology currently prescribed under the Income Tax Act, acts as a deterrent to employees from willing to accept and stay in company owned accommodation.

2) Secondly, employees exhibiting superior performance and staying in company owned accommodation, are getting demotivated since their take home salary after tax, turns out to be lower than a moderate performing employee due to following reasons:

(i) higher tax outflow towards perquisite value of accommodation which is linked to their higher salary vis-à-vis a lower salaried employee, even though both are staying in similar type of company owned accommodation;

(ii) where a superior performer's salary crosses the income slab [say above Rs.2 crores or above Rs.5 crores] due to perquisite valuation of their accommodation, then their incremental post tax income ends up lower compared to another employee staying in a similar accommodation, but earning below the slab (due to relatively lower performance rating).

3) The aforesaid inequitable treatment also discourages corporates from investing in infrastructure, including residential projects, across the country. It may be noticed that for this very reason, several corporates have been disposing of their residential properties across the country. At a time when the economy needs investments, it is submitted that the Govt. amends the perquisite valuation methodology for company owned accommodation such that corporates are incentivized to invest in the real estate sector (which is also a high employment intensive sector of the economy).

4) The definition of 'Salary' for the purpose of determining perquisite value of rent-free accommodation owned by employers and provided to employees is NOT aligned with the definition of 'Salary' for determining taxable value of HRA. In most cases, HRA paid by an employer becomes tax-free and the employee does not suffer any tax on account of accommodation. **This is another demotivating factor for employees from opting to stay in employer-owned accommodation.**

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Recommendation
1) It is suggested that in case of company owned accommodation, the concept of "fair rental value" be introduced to ensure that right amount of perquisite is determined for tax purposes instead of linking it to Salary drawn. "*Fair rental value*" for this purpose should be defined as the rent which a similar accommodation would realize in the same locality; where fair rental value is not ascertainable, then the municipal valuation should be considered for determining the perquisite value.

2) Without prejudice to the above recommendations, it is further recommended that the **definition of 'Salary'** for the purpose of determining perquisite value of rent-free accommodation owned by private sector employer provided to their employees [u/s 17(2)(ii)] **be aligned with the definition of 'Salary' under Fourth Schedule: Part A - Rule 2(h) to Income Tax Act** – i.e. considered for determining taxable value of HRA under Rule 2A of Income Tax Rules.

Proposed amendments to relevant provisions of Income Tax Act & Rules enclosed.

Proposed Amendment[2] **to Income Tax Act & Rules**

I. Section 17(2) "perquisite" includes-

(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;

Explanation. I – For the purpose of this sub-clause, concession in the matter of rent shall be deemed to have been provided if,-

(a) In a case where unfurnished accommodation is provided by any employer other than the Central Government or any State Government and-

(i) *[to be deleted]*

(ii) the accommodation is taken on lease or rent by the employer or is owned by the employer, the value of the accommodation being the actual amount of lease rental paid or payable by the employer or the amount the accommodation owned by the employer might reasonably be expected to let from year to year or fifteen percent of salary, whichever is lower, in respect of the period during which the said accommodation was occupied by the assessee during the previous year, exceeds the rent recoverable from, or payable by, the assessee.

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2 *Red colour represents deletion while Blue colour represents proposed inclusion/amendment*

(b) ……..

(c) in a case where a furnished accommodation is provided by an employer other than the Central Government or any State Government and-

(i) *[to be deleted]*

(ii) the accommodation is taken on lease or rent by the employer or is owned by the employer, the value of the accommodation determined under sub-clause (ii) of clause (a) as increased by the value of furniture and fixtures in respect of the period during which the said accommodation was occupied by the assessee during the previous year, exceeds the rent recoverable from, or payable by, the assessee.

(d) …..

Explanation 2.- ………..

Explanation 3.- The existing explanation to be substituted with the following:

For the purpose of this sub-clause, "salary" shall have the meaning assigned to it under clause (h) of rule 2 of Part A of the Fourth Schedule

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Annexure 2

<u>ESOP shares vis-à-vis Market Shares</u>

They are not comparable

1. ESOP shares are "issued" by the employer and "subscribed" to by the employee, whereas the shares acquired in the market ("market shares") are "transferred" from one shareholder to another. Consequently, while the market shares are goods, the ESOP shares do not become goods until they are allotted in favour of the subscribing employee.

2. It follows that the ESOP shares are not comparable with the shares that are already being traded. Therefore, it is incorrect to quantify any benefit to the employee with reference to the already trading shares or their so-called market value.

3. Even after allotment of the ESOP shares, the employee is prevented by law or the terms of the grant, from selling the shares during a lock-in period, whereas the shares bought in the market can be sold immediately without any restraint. The legal ability of disposition being one of the essential attributes of "property", the ESOP shares, unlike the market shares, are not property in the hands of the employee even after allotment.

4. When on the date of exercise, the shares are subject to a lock-in condition, they cannot be considered to be a benefit; and if it is a not a benefit, it ought not to be fictionally treated as benefit and brought under "perquisites". In ***CIT v. Infosys Technologies Ltd.,(2008) 2 SCC 272*****, at page 277**, the Supreme Court held as follows:

"During the said period, the said shares had no realisable value, hence, there was no cash inflow to the employees on account of mere exercise of options. On the date when the options were exercised, it was not possible for the employees to foresee the future market value of the shares. Therefore, in our view, the benefit, if any, which arose on the date when the option stood exercised was only a notional benefit whose value was unascertainable. Therefore, in our view, the Department had erred in treating Rs.165 crores as perquisite value being the difference in the market value of shares on the date of exercise of option and the total amount paid by the employees consequent upon exercise of the said options."

The Court further, at page 279, held:
"It is important to bear in mind that if the shares allotted to the employee had no realisable sale value on the day when he exercised his option then there was no cash inflow to the employee. It was not possible for the employee to know the future value of the shares allotted to him on the day he exercises his option."

It may be borne in mind that in the Infosys case, the Supreme Court dismissed the Government's appeal not only because the ESOP shares were not enumerated under "perquisites" in Sec. 17 (2) of the Act, but also because it does not amount to a benefit.

5. For this reason as well, the ESOP shares and the market shares are not comparable, and the latter cannot afford any basis for determining any benefit that may have accrued to the employee on account of the ESOP shares.

Discrimination

6. When a listed company issues IPO or rights shares at a price less than the market value (or bonus shares), the difference between the issue price and the market price is not taxed. If in such a case the difference does not take the character of income, it cannot be income in the case of ESOP shares too.

7. And, if such difference (in the case of IPO/rights/bonus) does take the character of income, then taxing ESOP share alone lacks any intelligible differentia that can validly explain this classification.

8. If a distinction is suggested on the ground that in the case of ESOP shares the benefit takes the character of income forming part of 'salaries' (which is apparent from treating it as "perquisite"); which is not so in the case of market shares, it would be incorrect because such income, especially in the nature of salaries, would flow to the employee only when he realizes a gain upon the sale of the shares and not by mere allotment. Therefore, this is not a meaningful distinction.

Valuation

9. The "market value" is taken as on the date of exercise. But the ESOP shares are allotted after a lapse of time, when the market value may not be the same.

10. Even the market value on the date of allotment would not be relevant because the employee would not be able to realize that "value", being prevented from selling the ESOP shares during the lock-in period.

11. Further, the issue of ESOP shares results in expanding the capital base, and a consequent reduction in the intrinsic value of the existing shares. For this reason also, the alleged benefit flowing from ESOP shares cannot be reckoned with reference to the current value of the already existing market shares.