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Do taxes cloud the novelty of SARs?

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Comparison between Stock Appreciation Rights and Employee Stock Option Plans

Conceptually different from the Employee Stock Option Plan *a.k.a* ESOP, a household term in India, Stock Appreciation Rights, also known as SARs are a novel way of rewarding the employees of an organisation by granting them the right to benefit from any appreciation in the value of the common stock (shares) of a corporation. The subtle difference between ESOP and SAR is that, under the latter, no shares actually get allotted to the employees in the first instance. In other words, what the employees actually get is a right to take advantage of the appreciation in the stock value *sans* actually holding the same. Therefore, it appears more attractive to employees because they would not be required to incur any cash outflow to purchase the shares. At the time when the employees decide to exercise their rights, depending on the how the plan is structured, the appreciation could be conveyed to the employees either in cash (phantom stocks) or by giving shares to the employees, for a value equal to the value of the appreciation in the shares. As far as the corporation is concerned, it is an effective way of compensating the employees by deferring the payment of bonus to a future date, thereby achieving a twofold objective of postponing the cash outflow and at the same time incentivising the employees to stay in the organisation.

Issues in income taxes with respect to SARs

What makes this instrument an exciting one is the challenge that it poses to the tax authorities and the accountants. While accountants will have to decide on what should finally go as debit to the Profit and Loss account and how to account for the time spread of this benefit conferred on the employees, the challenge in taxes is multifold. The following pointers would guide in understanding the complexity surrounding the taxation of SARs.

a) A parent company, say, located in the US decides to give SARs to the employees of its subsidiary in India, thereby granting them a right to gain from appreciation in the value of the US Corporation's stock. The employee on whom such a right is conferred is not on the rolls of the US Corporation. Therefore, an employer employee relationship is absent.

b) At the time of grant of SARs, nothing really accrues to the employee in monetary terms. He is merely given a right to benefit from the appreciation in the value of the common stock which right would be exercisable after a certain period when such rights actually vest in the hands of the employees. So, at the time of grant, would anything be taxed at all?

c) Upon exercise of the right, if the

compensation plan involves paying cash to the employee equal to the difference between stock value and the exercise price, then how should the sum be taxed in the hands of the recipient employee?

Arguments against taxation of benefits from SARs

It has been argued that in the absence of an employer-employee relationship between the parent corporation and the employees of the Indian subsidiary, the amounts received upon exercise of the SARs should not be taxable under the head 'Income from Salaries'. Further, it has also been argued that the amounts should be construed as capital gains since SARs would constitute capital assets, the receipts upon their exercise would have been taxed under the head 'Capital Gains'; however since the computation mechanism would fail (in the absence of a cost of acquisition), the same would not be eligible to taxation under the said head as well.

Deliberations

a. The SARs are allotted to the employees by virtue of the employer-employee relationship that exists between the Indian company and the employee.

b. Even though there is an absence of an employer-employee relationship in this case between the parent company and the Indian employees, it can be argued that the benefit stemming from SARs arises from the contract of employment and hence would be taxable under Section 17(1)(iv) of the Income Tax Act, 1961. The mere fact that the benefit is provided by the parent company would not alter the underlying obligation that necessitated such a conferment of benefit on the employee.

c. The proposition of treating SARs as a capital asset could be far-fetched for the following reasons:
   (i) SARs merely give a right to an employee to benefit from any appreciation in the value of the common stock of the Corporation.
   (ii) The said right solely vests with the employee and cannot be transferred by him to any other person.
   (iii) Any act by the employee to let the right lapse in a favourable scenario would not be compensated by the foreign parent which actually grants the SARs.

d. While it is correct to say that in a scenario where the argument is accepted, the computation mechanism would fail, it is also interesting to note that the exercise of SARs *per se* would also fail to fit the definition of transfer as provided in Section 2(47) of the Income Tax Act, 1961. It would nevertheless be interesting to place this argument before the courts as the argument in itself is not completely fallacious.

e. As regards the time of taxation, it is clear that no notional gains can be taxed in the hands of any person and hence at the time of grant of SARs, even though there could be a scenario where the commons stock of the corporation is traded above the exercise price of the SARs, nothing can be taxed in the hands of the employee.

f. At the time of exercise, any difference between the stock's market price and the exercise price which is monetised by the employees would be offered to tax.

Conclusion

To conclude, any gains arising out of SARs would be taxable under the head 'Income from Salaries' in India for the reason that while the form of the benefit is structured differently, it stems from the contract of employment between the Indian company and its employees. If any part of the monetisation of SARs has been taxed in the country of the parent company, the relief provisions in the respective DTAA or in the Indian Income Tax Act (in the absence of DTAA) would apply to the employee.

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Notifications and Circulars

Form for making application seeking immunity from penalty and prosecution, notified

Section 270AA of Income-tax Act, 1961 was inserted vide Finance Act, 2016 w.e.f 01-04-2017. As per Section 270AA(1) of Income-tax Act, 1961, an assessee may make an application to the Assessing Officer to grant immunity from imposition of penalty under Section 270A and initiation of prosecution under Section 276C or Section 276CC of Income-tax Act, 1961 subject to fulfilment of certain conditions.

By way of Notification No. 90/2016 dated 5-10-2016 CBDT has notified Rule 129 of Income Tax Rules, 1962 which provides that the application seeking immunity provided in Section 270AA(1) of Income Tax Act, 1961 shall be made in Form No. 68. The Form as notified requires the assessee to furnish the details of tax paid and to make a declaration that no appeal shall be filed for the matter in relation to which the immunity is being sought.

Rule for claiming expenditure incurred for obtaining rights to use spectrum for telecommunication services

Section 35ABA was inserted by Finance Act, 2016 w.e.f 01.04.2017 to provide the manner of claiming deduction for expenditure incurred, by taxpayers engaged in the business of telecommunication, for obtaining rights to use spectrum for telecommunication services. Sub-section (1) of section 35ABA provides that deduction for the expenditure incurred for obtaining spectrum rights will be allowed in equal proportion in all the years for which such rights have been obtained commencing with the year in which *actual payment has been made* by the assessee. CBDT, *vide* Notification no. 89/2016 dated 4-10-2016, has inserted Rule 6A in Income-tax Rules, 1962 to provide that the term 'actual payment has been made' as used in section 35ABA shall mean-

a) The actual payment of expenditure, irrespective of the year in which the liability was made in the books of accounts of the assese, where an assessee has been allowed by the Department of Telecommunications to make the full payment.

b) The amount which would have been payable by the assessee had he opted for full upfront payment, irrespective of the year in which the liability was made in the books of accounts of the assese, where an assessee has been allowed by the Department of Telecommunications to make deferred payment.

Revised Income Computation and Disclosure Standards

In exercise of powers conferred under section 145(2) of Income-tax Act, 1961, CBDT had notified ICDS *vide* Notification No. 32/2015 dated 31.03.2015. The notification stated that the standards would be applicable for computing income for A.Y. 2016-17. However, CBDT had notified by press release dated 06th July 2016, that owing to the amendments suggested to the standards by the Expert Committee, the standards would be applicable from A.Y. 2017-18.

In line with this press release, CBDT has notified revised ICDS to be applicable from A.Y. 2017-18 *vide* Notification No. 87/2016. Certain key changes to the ICDS are as under:

S.No.	ICDS	ICDS as notified on 31.03.2015	ICDS as notified on 29.09.2016
1.	III- Relating to construction contracts	No transitional provision	Standard to apply only to contracts commenced after 01.04.2016. Construction cost and revenue in respect of contracts commenced prior to 01.04.2016 to be recognised as per method of accounting regularly followed by assessee
2.	IV- relating to revenue recognition	● Revenue from service to be recognised on Percentage Completion Method ● Interest incomes to be recognised on accrual basis	● Revenue from service still to be recognised on Percentage Completion Method. However, it is now provided that when services are provided by an indeterminate number of acts, revenue may be recognised on a straight line basis over the specific

S.No.	ICDS	ICDS as notified on 31.03.2015	ICDS as notified on 29.09.2016
			period. Further provided that Revenue from service contracts with duration of not more than ninety days may be recognised when the rendering of services under that contract is completed or substantially completed ● Interest incomes to be recognised on accrual basis. However, interest income on refund of any tax, duty or cess shall be recognised in the year of receipt
3.	VI – relating to Effects of changes in foreign exchange rates	● operations to be classified as integral and non-integral operations. Different treatment for translation depending on classification of foreign operation ● Non-monetary items to be converted into reporting currency by using exchange rate at the date of conversion	● Classification of foreign operations done away with ● No change for valuing non-monetary items (other than inventory). Non-monetary items being inventory which is carried at net realizable value denominated in a foreign currency shall be reported using the exchange rate that existed when such value was determined
4.	IX- relating to borrowing cost	● Amount of borrowing cost to be capitalized to be computed by multiplying total borrowing cost with average of qualifying assets and dividing it by the average of total assets	● Amount of borrowing cost to be capitalized to be computed by using the same formula. However, clarified that for the purpose of such formula qualifying assets will mean assets that necessarily require a period of twelve months or more for its acquisition, construction or production

Ratio decidendi

Proceedings cannot be continued against transferor entity after merger

The taxpayer got amalgamated with the transferee with effect from 1 April 2012. Assessment proceedings for Assessment Year (AY) for 2010-11 were completed in the name of taxpayer despite the fact of merger having been brought on record by the transferee. Appeal was filed in the name of taxpayer and later an application to substitute the name of transferee was also filed. The Income Tax Appellate Tribunal (ITAT) held that no assessment can be framed in the name of a non-existent company. Resultantly the ITAT also held the appeal proceedings to be invalid. [*DCIT* v.*Zenta Knowledge Services (P) Ltd., ITA 882/Mds/2015*]

Transfer pricing - Manner of computing RPT and functional comparability

The taxpayer was engaged in the business of providing Information Technology (IT) services and Information Technology enabled Services (ITeS) to its US based parent company. The Transfer Pricing Officer (TPO) introduced some comparable companies and while opposing the TP addition following issues emerged:

a) *Manner of computing Related Party Transaction (RPT) Filter:* TPO arrived at RPT by dividing RPT sales by aggregate of Total sales and total expenditure. Taxpayer contended that there is no RPT expense the same cannot be taken in denominator. ITAT accepted the argument of taxpayer and High Court affirmed the order of ITAT.

b) *Functional comparability:* TPO contended that companies engaged in sale of software products can be compared with taxpayer. ITAT rejected this contention and High Court held that the order of ITAT has not been proved to be perverse and accordingly decided the issue in favour of the taxpayer.

c) *Fiscal period:* Taxpayer was adopting Financial Year while the comparable selected by TPO had adopted 1 July to 31 June as its fiscal period. High Court held that such comparison is not supported by Rule 10B and companies adopting different fiscal period cannot be taken as comparable.

d) *Outsourcing entity not a comparable:* Taxpayer contended that one of the comparable taken by TPO namely Vishal Infotek is also engaged in outsourcing activities hence not a comparable. ITAT accepted this argument. High Court rejected the appeal of revenue and observed that the issue is purely factual and does not give rise to a substantial question of law.

e) *ITeS is not comparable to KPO and LPO:* ITAT accepted the contention of the taxpayer that Knowledge Process Outsourcing and Legal Process Outsourcing require superior level of manpower and on that count not comparable with ITeS segment of taxpayer. High Court rejected the appeal of revenue and observed that the issue is purely factual and does not give rise to a substantial question of law. [*CIT* v. *PTC Software (I) Pvt. Ltd.*, ITA 732 of 2014 – Bombay High Court]

Aggregation of payment of royalty with other international transactions

The taxpayer in this case had entered into a set of international transactions including import of raw material and equipment, export of components, management services and payment of royalty etc. In its TP study, it had adopted TNMM on an aggregate basis as the most appropriate method. The TPO held that the assessee failed (a) to prove the benefit obtained by receiving the know-how and also (b) to demonstrate receipt of technology. ITAT held that TPO was not justified in applying benefit test and that the factum of obtaining technology was evident from the agreements filed before the TPO. Accordingly, it upheld the approach of taxpayer in applying TNMM on an aggregate basis. [*Luwa India P Ltd* v. *ACIT*, IT (TP) A No. 568/Bang/2012, Order dated 26-8-2016, ITAT, Bangalore]

Recovery of fee under section 234E for period prior to 1 June 2015

The taxpayers were served with notices under Section 200A calling upon them to pay fee under Section 234E for Financial Year (FY) 2012-13 & 2013-14. They challenged the constitutional validity of Section 234E. The High Court observed that the payment of fee under Section 234E protects the defaulter from penalty under Section 271H and hence the test of *quid pro quo* is satisfied. It however refrained from giving its final verdict on the constitutional validity for the reason that in the present case the exercise would be academic in nature. The High Court allowed the petition on the alternative ground that the recovery provision under Section 200A introduced with effect from 1 June 2015 being substantive in nature cannot be invoked for recovering the fee pertaining to an earlier period. [*Shri Fatheraj Singhvi and others* v. *UOI and others* W.P. 2663 – 2666 / 2015 / (T-IT), Karnataka High Court]

Taxability of offshore supplies in case of a turnkey contract

In this case the taxpayer, a Singaporean entity was awarded a contract to undertake structural glazing and wall cladding work for Terminal T-3 of Delhi International Airport Limited. The taxpayer had claimed that income arising from offshore supply of goods is not taxable in India. The Authority for Advance Rulings rejected this contention on account of following reasons:

a) The agreement was silent about the time when title in offshore supply goods will pass;

d) The consideration for offshore supply was not separately expressed in the contract. All that the contract mentioned was milestone payments;

c) Taxpayer admittedly had a project office in India which provided technical and engineering inputs to facilitate procurement of material for offshore supply. Thus PE in India was involved in offshore supply function which fact was not present in the case of Ishikawajima v. CIT 288 ITR 408 (SC);

d) Taxpayer retained effective control over goods till installation, paid customs duty on import and bore risk till completion of the work. [*MERO Asia Pacific Pte Ltd.*, In Re [2016] 73 Taxmann.com 17 (AAR-New Delhi)]

Interest on refund where delay attributable to taxpayer's conduct

The taxpayer in this case had received subsidy under an incentive scheme of Government and offered the same to tax as a revenue receipt in its return of income. During the assessment proceedings it filed a letter claiming the said subsidy as a capital receipt not chargeable to tax. The Assessing Officer (AO) did not accept this claim but, in appeal before CIT(A) it was accepted. However the AO granted refund with interest computed from the date on which the letter was filed by the taxpayer claiming the subsidy as non-taxable capital receipt. Taxpayer contended that interest should be computed from the first day of assessment year. AO's contention was that intervening period was a delay attributable to the conduct of taxpayer. High Court upheld the contention of the taxpayer and observed that the delay dealt with the Section 244A is 'delay in any proceedings' and not the delay in raising a legal claim. The interest was thus directed to be computed from first day of the assessment year. [*Ajanta Manufacturing Limited* v. *DCIT* Special Civil Application No. 6830 and 6832 of 2016, Gujarat High Court]

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