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*Analysing developments impacting business*

### PROFIT ON TRANSFER OF SHARES ACQUIRED UNDER STOCK OPTION PLAN TAXABLE AS 'CAPITAL GAIN' NOT 'SALARY'

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The Chennai Bench of the Income Tax Appellate Tribunal (Tribunal) in a recent ruling in *Dr. Muthian Sivathanu v Assistant Commissioner of Income-tax* [ITA No. 553/2018] held that proceeds received on sale of shares acquired pursuant to exercise of an employee stock option (Option) will be taxable as capital gains and not as salary. Further, it observed that if an individual was a non-resident, employed by a foreign company and providing services abroad, any income viz., shares derived from exercise of the Option will not be taxable in India as the same will be considered to be accruing outside India.

#### Background

In the instant case, prior to the tax year in consideration, the taxpayer was employed with a foreign company (Google USA), and was a non-resident under the Income Tax Act, 1961 (Act). During his employment, the taxpayer exercised the Options offered by Google USA. Subsequently, the taxpayer was employed with the Indian subsidiary of Google USA (Google India) and became a tax resident under the IT Act. At this stage, Google USA sold the shares held by the taxpayer on his behalf and remitted the proceeds to him through Google India. In its withholding tax return (Form 16), Google India declared that the proceeds were in the nature of salary. However, the taxpayer in his tax return offered the proceeds derived from the sale as income from capital gains.

During the assessment proceedings, the tax authorities rejected the treatment of the proceeds as capital gains. It was of the view that the proceeds were in addition to the salary which the taxpayer would receive under the contract of employment. Moreover, Google India, which paid the proceeds to the taxpayer, had declared in the Form 16 that the proceeds were in the nature of salary.

#### Tribunal Ruling

The Tribunal observed that at the time of exercise of Options, the taxpayer, who was employed with Google USA, was a 'non-resident' under the provisions of the Act and was rendering services abroad. Hence, the income derived from the exercise of the option was not taxable under the IT Act given that the income accrued to the taxpayer outside India. The Tribunal further observed that the taxpayer was already holding the shares, hence the income derived from the transfer of such shares would constitute capital gains, and not perquisite, and thus would not be taxable as salaries. It is important to note that while arriving at this conclusion, the Tribunal observed that while determining the treatment of the income derived from sale of shares allotted under an

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equity incentive plan, reliance would solely be placed on the provisions of the Act, and not the Form 16 issued by the employer.

## Comment

Salary income is taxable at a progressive slab rate whereas capital gains are taxed at a flat rate (unless it is in the nature of short-term capital gain). Further, capital gains are taxed on the difference between the sale consideration and cost of acquisition of the asset. In a simpliciter equity incentive plan, from an employee perspective, there are income-tax implications at two levels. One - at the time of allotment of shares, which is taxed as salaries; and Two - at the time of transfer of such shares, which is taxed as capital gains. The ruling confirms this position of taxing income arising from equity incentives.

Interestingly, though the question of taxability of income upon allotment of shares at the time of Options was not before the Tribunal, the ruling does make an important observation in that regard. It rightly stated that if the taxpayer was a non-resident at the time and employed abroad, the income arising on exercise of Options cannot be brought to tax in India.

In recent times, equity incentive plans have become intricate and complex and the employees are always on the move. The reaffirmation of the above-mentioned two principles would provide the needed clarity in assessing the tax implication in the hands of the employees arising from such plans.

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