

Global Rewards Update: INDIA

December 2009

INDIA TRIBUNAL RULES INDIAN COMPANY CANNOT DEDUCT STOCK OPTION EXPENSE

BACKGROUND

Ranbaxy Laboratories Ltd ("Ranbaxy"), an Indian Company that is traded on an Indian stock exchange, had granted stock option awards to its employees in fiscal years 2001-2002 and 2002-2003, and sought to take a tax deduction on the difference between the fair market value of the underlying shares and the exercise price of the option, beginning in each of the respective grant years; the awards granted had a 5 year graded vesting schedule and, in accordance with accounting standards prescribed by the Securities and Exchange Board of India ("SEBI"), Ranbaxy expensed 1/5 of the spread at grant in its own financial statements each year over the vesting period. Believing that it was entitled to a corresponding tax deduction for the expense entered on its financial statements, Ranbaxy sought to take a corporate tax deduction each year equal to the expense entered on its financials (i.e. 1/5 of the difference between the fair market value of the shares on the date of grant and the exercise price of the shares in Year 1, 1/5 of the difference between the fair market value of the shares on the date of grant and the exercise price of the shares at grant in Year 2, etc.). The Assessing Officer (AO) denied this deduction on the grounds that Ranbaxy had not incurred any actual cost with respect to these awards in any of the tax years at issue.

LEGAL ACTION

Ranbaxy appealed the AO's determination to the Commissioner of Income-tax (Appeals) ("CIT (A)"), the first level of appeal for taxpayers in India. The CIT (A) ruled against the AO and held that the deduction is allowable in the year in which the option is exercised by the employee. The CIT (A) found that this is the point when the employer's liability becomes certain.

Both Ranbaxy and the tax authorities took issue with the ruling (on separate grounds), and the case was appealed to the Delhi Bench of the Income-tax Appellate Tribunal ("ITAT") where, on June 12, 2009, the ITAT held that local Indian companies may not take a tax deduction for stock option awards granted to their Indian employees. The Delhi Bench of the ITAT has confirmed that employers may not take a deduction for either the discount at grant or the spread at exercise (equal to the difference between the fair market value of the underlying shares at exercise less the exercise price paid), as the employer's expense is only "notional" in nature.

In reaching this ruling, the ITAT found that the difference between the fair market value of the shares and the exercise price represents a discount to the employee on the underlying shares, and this discount is not an actual expenditure incurred by the employer/taxpayer. In other words, the employer has not expended any amount in granting these awards, but rather has only forgone the opportunity to collect a portion of the share price. The ITAT also confirmed that SEBI guidelines are not the dispositive factor in determining whether an item will be considered an allowable income tax deduction. If Ranbaxy chooses to appeal this decision, the company may bring its appeal before the Delhi High Court and, ultimately, the Supreme Court.

The decision in the Ranbaxy case, while not binding precedent in any jurisdiction other than Delhi, will have persuasive value. In Delhi, taxpayers seeking to take a corporate tax deduction for their stock option awards will continue to have their cases decided on a case-by-case basis, though the Ranbaxy decision will be binding on all AO's (i.e. Delhi AO's must deny a corporate tax deduction for the stock option award expense). Tribunals in jurisdictions other than Delhi may look to the Ranbaxy decision for guidance, though they will not be required to follow the Ranbaxy holding when deciding the cases in their respective jurisdictions.

Of note, neither the CIT (A) nor the ITAT considered the situation where stock options are granted to Indian employees by a non-Indian company (e.g. the U.S. parent company of an Indian subsidiary) and the costs of such awards are recharged to the local Indian entity.

ACTION

- While it is expected that Indian employers will still be allowed a corporate tax deduction for cash-settled awards, the costs associated with other types of share-settled awards (e.g. stock-settled RSUs) will likely be deemed "notional," similar to the costs associated with stock options. As such, Indian employers granting stock awards to their Indian employees should review their equity award programs and reconsider whether share-settled awards, as opposed to cash-settled awards, are the most cost-effective approach.
- Non-Indian companies granting stock options to employees of an Indian subsidiary/joint

venture etc., and recharging the costs of these awards to such local entity, should contact their tax professionals to discuss their ability to take a deduction for these awards in India.

People to Contact

For assistance in this matter or any other issue related to the operation of your global rewards plans, please contact your local Deloitte global rewards consulting services advisor or email us at: globalequity@deloitte.com and a global rewards consultant will contact you.

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