



Tax alert: FMV on exercise of ESOP allowed as cost of acquisition, even if perquisite not taxable

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The Mumbai Bench of the Income-tax Appellate Tribunal (ITAT) has held that a taxpayer is allowed to adopt the fair market value (FMV) of the shares on the date of exercise of ESOPs (taxpayer was non-resident on date of exercise), determined under section 17(2)(vi) read with Rule 3(8)(ii) of the Income-tax Rules 1962, as cost of acquisition under section 49(2AA) for computing capital gains on subsequent sale of such shares.

In a nutshell



Section 49(2AA) of the ITA refers to the FMV for determining value of the perquisite in accordance with the mechanism prescribed. The provision does not stipulate that such perquisite should have actually been subjected to tax in India or included in the total income of the taxpayer.



To read into section 49(2AA) an additional requirement that the perquisite must have been taxed in India, would amount to supplying words which the legislature has consciously omitted.



The applicability of section 49(2AA) cannot depend upon the jurisdiction in which the perquisite has been subjected to tax, since the provision itself makes no such distinction. Once the FMV has been determined and considered for the purposes of section 17(2)(vi), the statutory requirement of section 49(2AA) is met. To import an additional condition that the perquisite must have been taxed in India, would amount to supplying words to the statute, which is impermissible in law.



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Background:

- The taxpayer¹, an individual, was a resident of the United Kingdom (UK) and was employed with UK branch of an Indian company.
- Based on the details/information available with the Revenue, the taxpayer had not filed return of income for the Financial Year 2017-18 corresponding to Assessment Year 2018-19 and no assessment was made.

Based on the details/information available in the Revenue's system regarding a financial transaction entered by the taxpayer, related to foreign purchase of currency during the relevant financial year, the taxpayer's case was reopened. The Revenue was of the opinion that the income chargeable to tax represented in the form of an asset, had escaped assessment.

- The taxpayer, inter-alia, submitted as follows:
 - He did not file the return of income for the year under consideration, as he was unaware about the requirements to file the return of income of India. He had no intention of avoiding or evading the taxes in India by not disclosing the income in India.
 - He had exercised Employee Stock Option Plans (ESOPs) and was allotted shares at an exercise price of, say, INR 1 per share. The fair market value (FMV) of the shares on the date of exercise was, say, INR 170 per share.
 - The difference between the FMV (INR 170) and the exercise price (INR 1), represented the perquisite value under section 17(2) of the Income-tax Act, 1961 (ITA). The aforesaid perquisite did not accrue or arise in India as the ESOPs were exercised by the taxpayer wholly outside India and pertained to employment rendered outside India. Therefore, the perquisite was neither received nor deemed to accrue or arise in India and consequently fell outside the scope of total income under the ITA.
 - The taxpayer thereafter sold the shares (on different dates) during the relevant financial year. While computing the capital gains arising on the sale of the aforesaid shares, the taxpayer adopted the FMV of INR 170 per share as on the date of exercise of the ESOPs as the cost of acquisition (COA) in terms of section 49(2AA) of the Income-tax Act, 1961 (ITA) [Section 73 of the Income-tax Act 2025] and accordingly computed a short-term capital loss (STCL).
 - The difference between the FMV of the shares and the exercise price had already been subjected to tax as a perquisite in the United Kingdom.
- The Assessing Officer (AO), after considering the return of income filed pursuant to reassessment proceedings and the submissions made by the taxpayer, proposed an addition as unexplained short term capital gains (STCG) against the STCL offered by the taxpayer. The same was on the basis that the Cost Of Acquisition (COA) was the actual consideration paid by the taxpayer for purchasing the shares which was INR 1 for the acquisition of the capital asset as against INR 170 claimed by the taxpayer.
- Aggrieved, the taxpayer filed objections before the Dispute Resolution Panel (DRP), which upheld additions as unexplained STCG.
- Aggrieved, the taxpayer filed an appeal before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions of the ITA**49. Cost with reference to certain modes of acquisition**

... ***“2(AA) Where the capital gain arises from the transfer of specified security or sweat equity shares***

¹ Rajesh R Hemrajani vs. ITO, Int. tax, Mumbai [2026] 189 taxmann.com 183 (Mumbai - Trib.)

referred to in sub-clause (vi) of clause (2) of section 17, the cost of acquisition of such security or shares shall be the fair market value which has been taken into account for the purposes of the said sub-clause.”

17. "Salary", "perquisite" and "profits in lieu of salary" defined.

...“(2) "perquisite" includes—...

...(vi) the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.”

Rule 3 of the Income-tax Rules 1962- Valuation of perquisites

...“(8)(i) For the purposes of sub-clause (vi) of clause (2) of section 17, the fair market value of any specified security or sweat equity share, being an equity share in a company, on the date on which the option is exercised by the employee, shall be determined in accordance with the provisions of clause (ii) or clause (iii).

(ii) In a case where, on the date of the exercising of the option, the share in the company is listed on a recognized stock exchange, the fair market value shall be the average of the opening price and closing price of the share on that date on the said stock exchange...”

Decision of the ITAT:

The ITAT acknowledged that the issue for consideration was whether the transfer of the shares of an Indian company gives rise to capital gains chargeable to tax in India. Secondly, if the gains are so chargeable, whether for the purposes of computing capital gains, the COA was to be taken as the FMV of the shares on the date of exercise by the taxpayer.

In this regard, the ITAT held as follows:

- Ordinarily, the COA denoted the amount incurred by a taxpayer for acquiring a capital asset.
However, the legislature had recognised that a capital asset may be acquired otherwise than by purchase and therefore, the actual amount paid may not always represent the true cost for the purposes of computing capital gains. Accordingly, section 49 of the ITA provides for deeming provisions governing the determination of the COA in specified situations where the asset is acquired by modes other than direct purchase.
- Section 49(2AA) of the ITA stipulates that where capital gains arise on the transfer of specified securities or sweat equity shares, the COA shall be the FMV which has been ‘taken into account’ for the purposes of valuation of the perquisite under section 17(2)(vi) of the ITA. Thus, in respect of ESOPs and sweat equity shares, the legislature has consciously avoided the general rule of actual cost and has statutorily substituted the FMV adopted for perquisite valuation as the COA for the purposes of computing capital gains.
- Section 49(2AA) of the ITA refers to the FMV for determination of the value of the perquisite in accordance with the mechanism prescribed. The provision does not stipulate that such perquisite should have actually been subjected to tax in India or included in the total income of the taxpayer. The distinction is significant because the computation of the perquisite under section 17(2)(vi) and its ultimate chargeability to tax, operate in different fields.
- To read into section 49(2AA) an additional requirement that the perquisite must have been taxed in India, would amount to imply what the legislature has consciously omitted. It is a settled principle of statutory interpretation that courts cannot add words to a statute under the guise of interpretation when the language employed by Parliament is plain and unambiguous.

- The ITAT also distinguished reliance on earlier rulings² placed by the Revenue / DRP.
- The applicability of section 49(2AA) of the ITA could not depend upon the jurisdiction in which the perquisite had been subjected to tax, since the provision itself makes no such distinction. Once the FMV was determined and taken into account for the purposes of section 17(2)(vi) of the ITA, the statutory requirement of section 49(2AA) of the ITA stood satisfied. To import an additional condition that the perquisite must have been taxed in India would amount to supplying words to the statute, which is impermissible in law.

In view of the above, the ITAT held that the taxpayer was entitled to adopt the FMV of the shares as on the date of exercise, determined in accordance with section 17(2)(vi) of the ITA read with Rule 3(8)(ii) of the Income-tax Rules, 1962 as the COA under section 49(2AA) of the ITA while computing the capital gains arising on the subsequent transfer of the shares. Further, the contrary view adopted by the AO and DRP, by restricting the COA to the exercise price of INR 1 per share, was contrary to the plain language of section 49(2AA) of the ITA and, therefore, could not be sustained.

Comments:

Employee Stock Option Plans (ESOPs) are a common form of employee compensation, enabling employees to acquire shares of their employer at concessional price, subject to specified vesting and exercise conditions.

Section 17(2)(vi) of the Income-tax Act, 1961 (ITA) provides for taxation of the ESOP benefit as a perquisite, generally measured as the difference between the fair market value (FMV) of the shares on the exercise date and the exercise price. Section 49(2AA) of the ITA deems the FMV already factored into the perquisite computation under section 17(2)(vi), read with Rule 3(8)(ii), as the COA for such shares.

However, section 49(2AA) does not expressly specify that this benefit on the perquisite should be subject to tax in India. This distinction becomes critical for employees, where the taxability of the ESOP perquisite may be governed by residency, or a tax treaty- potentially resulting such perquisite not subject to Indian taxation altogether. The ITAT, in this ruling, lays down a broader principle on the COA to be taken for computing relevant capital gains at the time of ultimate sale of such shares (acquired on ESOPS) irrespective of the taxability (or non-taxability) of the corresponding perquisite.

The ITAT in this ruling, has *inter-alia*, held the following:

- Section 49(2AA) of the ITA refers to the FMV for determining value of the perquisite in accordance with the mechanism prescribed. The provision does not stipulate that such perquisite should have actually been subjected to tax in India or included in the total income of the taxpayer.
- To read into section 49(2AA) an additional requirement that the perquisite must have been taxed in India, would amount to supplying words which the legislature has consciously omitted.
- The applicability of section 49(2AA) cannot depend upon the jurisdiction in which the perquisite has been subjected to tax, since the provision itself makes no such distinction. Once the FMV has been determined and considered for the purposes of section 17(2)(vi), the statutory requirement of section 49(2AA) is met. To import an additional condition that the perquisite must have been taxed in India, would amount to supplying words to the statute, which is impermissible in law.

ESOPs taxation may vary based on residential status of the employee. In case of a resident taxpayer the entire perquisite value may be taxable in India and thus, the perquisite value is treated as the cost of acquisition as per section 49(2AA) of the ITA. However, for a non-resident taxpayer the perquisite value may be taxable wholly,

² Ramamurthy Sridharan v. ACIT [IT Appeal No. 1238 (Hyd) of 2008] and Biplab Adhya vs. Income-tax Officer, IT [2023] 146 taxmann.com 132 (Bangalore - Trib.)

partly or not taxable depending, inter alia, on the place of rendition of service during the vesting period. It is pertinent to note that, in the present case, the ESOP perquisite arising on the exercise of the stock options was not chargeable to tax in India as the ESOPs were exercised by the taxpayer wholly outside India and pertained to employment rendered outside India.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.



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