INSIGHTS

Direct Tax

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ITAT Mum | FMV adopted for ESOP perquisite treated as cost of acquisition under Sec. 49(2AA) for computing capital gains, even where the perquisite is taxed outside India [1]

Background

As per Sec. 17(2)(vi) of the Act, where an employer allots shares under an ESOP scheme (ESOP shares) to an employee, free of cost or at a concessional rate, the difference between the fair market value (FMV) on the date of exercise and the amount recovered from the employee, is taxable as a 'perquisite' under the head "Salaries" in the year of allotment.

When the shares so allotted are subsequently transferred by the employee, the resulting gains are chargeable under the head "Capital Gains".

To prevent the perquisite element from being taxed again as capital gains, Sec. 49(2AA) provides that where the capital gain arises from the transfer of such ESOP shares referred to Sec 17(2)(vi), *"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."*

Under Sec. 9 read with Sec. 5 of the Act, salary accrued or arisen to a non-resident for services rendered outside India, are not taxable in India.

In a significant ruling on cross-border ESOP taxation, the Mumbai ITAT has held that a non-resident employee who exercised ESOPs of an Indian company while employed overseas, and whose perquisite was taxed in the foreign jurisdiction and not in India, is nevertheless entitled to adopt the FMV on the date of exercise as the cost of acquisition under Sec. 49(2AA) of the Act for computing capital gains taxable in India.

[1] Mr. Rajesh R Hemrajani v. ITO INT. TAX [ITA 1284/MUM/2025] (Mum Trib.)

The Tribunal ruled that Sec. 49(2AA) only provides that cost of acquisition shall be taken as the FMV used for calculating the ESOP perquisite under Section 17(2)(vi) and does not require the perquisite *per se* to be taxed in India.

Brief Facts

- The taxpayer, an individual and a non-resident, was a tax resident of the United Kingdom during the relevant year, employed with L&T Infotech Ltd. (UK Branch), and held a Tax Residency Certificate certifying UK residency for the period 01.04.2018 to 31.03.2019.
- As part of his remuneration, the taxpayer was granted 7,700 ESOPs in AY 2017-18 in respect of equity shares of L&T Infotech Ltd. (an Indian listed company) at an exercise price of Re. 1 per share, vesting in five equal annual instalments of 20% each. The FMV per share as on the exercise date was ~ Rs. 1,754/-
- During AY 2019-20, the taxpayer exercised the vested options, and the perquisite element per share (i.e. Rs. 1754 - Re1 = ~Rs.1753) was subjected to tax in UK as part of the taxpayer's salary income.
- Subsequently, in the same year, the taxpayer sold the shares through the recognised stock exchange and computed capital gains taxable in India by adopting the FMV as on exercise date i.e. Rs. 1,754 as the cost of acquisition under Sec. 49(2AA).
- The AO restricted the cost of acquisition to the actual exercise i.e. Re. 1 per share, on the footing that, since the perquisite did not accrue or arise in India, the benefit of Sec. 49(2AA) was not available. The AO accordingly proposed an addition under the

head capital gains, which was upheld by the DRP.

Taxpayer's contentions

- Relying on the decision of Biplab Adhya v. ITO[2], the taxpayer contended that for computing capital gains, the cost of acquisition as per Sec. 49(2AA) *"necessarily includes the value which has already been subjected to tax as a perquisite under Sec. 17(2)(vi)"* and that *"legislature has consciously linked the cost of acquisition with the fair market value adopted for the purposes of Section 17(2)(vi), and not with the amount actually paid by the employee"*.
- Further, since the income had already been taxed in the UK, adopting only the exercise price as the cost would result in double taxation, undermine the scheme of Sec. 49(2AA), and violate the non-discrimination provisions of Article 26 of the India-UK DTAA.
- The taxpayer also distinguished the authorities relied upon by the AO on the ground that they pertained to residents, whereas his non-resident status was undisputed and accepted by the AO.

Revenue's contentions

The revenue distinguished the decision of Biplab Adhya v. ITO *(supra)* on the ground that, in that case, the perquisite had suffered tax in India whereas here it had suffered tax in the UK.

Tribunal's Ruling

The key issue before Tribunal *was - whether* the expression **"taken into account"** used in Sec. 49(2AA) necessarily requires that *"the perquisite should have been subjected to tax in India, notwithstanding that the FMV has been determined in accordance with the statutory mechanism prescribed under Sec. 17(2)(vi) read with Rule 3."*

Key observations made by the Tribunal are summarised below:

- **The expression "Taken into account" used in Sec 49(2AA) does not mean "taxed in India"**

  In respect of ESOPs to in Sec. 17(2)(vi), the legislature has statutorily provided for a cost step up under Sec. 49(2AA) by using the expression "*fair market value which has been taken into account for the purposes of Sec. 17(2)(vi)".*
  It does not state that such FMV should actually have been subjected to tax in India or included in the total income of the taxpayer.
  The expression is of wider import and merely refers to the FMV determined in accordance with Sec. 17(2)(vi) read with Rule 3.

- **Charge on income and its computation mechanism operate in different fields**

  The determination of perquisite value under Sec. 17(2)(vi) is distinct from its ultimate chargeability to tax, which is governed independently by Sec. 4, 5 and 9 and, where applicable, by the relevant DTAA.

  The Tribunal observed that *"to read into Sec. 49(2AA), an additional requirement that the perquisite must have been taxed in India would amount to supplying words that the legislature has consciously omitted"*, this being impermissible when the statutory language is plain and unambiguous.

- **Jurisdiction of taxation of the perquisite is irrelevant**

  The Tribunal held that the applicability of Sec. 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 is

[2] Biplab Adhya v. DCIT ITA No.720/Bang/2022.(Bang Trib.)

determined and taken into account for Sec. 17(2)(vi), the statutory requirement of Sec. 49(2AA) stands satisfied.

Our Comments

This ruling is a welcome clarification for internationally mobile employees and expatriates, confirming that cost step up benefit under Sec. 49(2AA) is available even where the ESOP perquisite has been taxed in a foreign jurisdiction and not in India.

This issue had never succeeded on a fully reasoned view, more so as the decision of Biplab Adhya *(supra)*, is a non-speaking remand on the core issue, though it is superficially supportive.

Further, the Mumbai ITAT has distinguished the revenue-favouring ruling by Hyderabad Tribunal in *Ramamoorthy Sridharan v. ITO*[3] on the ground that it did not address the question - **whether the phrase *"taken into account"* in Sec. 49(2AA) requires the ESOP perquisite to be mandatorily taxed in India?**
However, this issue may not be fully settled, given that the quantum dispute in *Ramamoorthy Sridharan* remains pending before the High Court.

It may also be interesting to analyse a scenario where, a non-resident whose ESOP perquisite bore no foreign tax. Whether the FMV as on exercise date would still substitute the Indian cost or whether the current ruling's ratio decidendi[4] cannot be applied to a new situation resulting in double non taxation.

ITAT Mumbai | Fiscal Transparency determines Foreign LP's 'Company' status under India-US DTAA [5]

Background

Under the Act, the due date for filing the return of income differs across categories of taxpayers.

Where a return of loss is filed beyond the prescribed due date, the benefit of carry-forward of such loss is denied under the Act. Therefore, the category under which a taxpayer falls i.e. whether a partnership firm or company, directly governs both the due date and consequentially the eligibility to carry forward losses.

Sec. 2(23)(i) of the Act assigns to a "firm" the meaning given in the Indian Partnership Act, 1932 and extends it to a Limited Liability Partnership (LLP) as defined in the LLP Act, 2008.

The definition of "company" in Sec. 2(17) includes a body corporate incorporated under the laws of a country outside India. However, where the taxpayer is a non-resident, the classification exercise is further influenced by the applicable Double Tax Avoidance Agreement (DTAA/Treaty).

Under the Treaty, Article 3(1)(f) of the India-USA Treaty defines the term "company" as any body corporate or any entity which is treated as a company or body corporate for tax purposes.

Article 4 of the India-USA Treaty defines the 'residence of a person' to mean the jurisdiction in which it is liable to tax under the law of that jurisdiction by reason of factors such as domicile, residence, citizenship, place of management, place of incorporation, or any similar connecting factor.

[3] Ramamoorthy Sridharan v. ITO Hyderabad [ITA No.1238/Hyd/2008] (Hyd. Trib)
[4] ratio decidendi means "reason for the decision"

[5] Pabrai Investment Fund IV, L.P v. Asst Director of Income Tax [ITA No. 637/Mum/2025] (Mum Trib.)

However, in case of partnerships, there is a specific provision where the person or entity is considered resident of a particular jurisdiction only if income derived from the partnership is subject to tax in that jurisdiction either:

- in the hands of the entity itself; or
- in the hands of its partners.

In a significant ruling touching the status of foreign fund vehicles, the Mumbai ITAT has held that a Limited Partnership (LP) formed under the laws of Delaware, USA cannot be treated as a 'firm' in India merely because it obtained a PAN bearing the status letter 'F' and filed its return in Form ITR-5. The Tribunal held that a corporate taxpayer incorporated outside India falls outside the definition of 'firm' under the Act, and that whether such an LP is a 'company' must be examined under Article 3 read with Article 4 of the India-US DTAA.

The Tribunal drew support from Article 4(1)(b) to examine the tax character of the US LP and observed that that the answer turns on whether the LP is taxed as an entity or is fiscally transparent (i.e. taxed in the hands of its partners), and therefore restored the matter to the AO, with the consequence that the correct return due date, and hence the eligibility to carry forward short term capital loss (STCL), would follow from that determination.

Brief Facts

- ∞ The taxpayer is a non-resident Limited Partnership incorporated in Delaware, USA and registered with SEBI as an FPI.
- ∞ It obtained a PAN with the status of a firm and, accordingly, filed its return for AY 2018-19 in ITR-5, claiming carry-forward of STCL.
- ∞ While processing the return under Sec. 143(1), the CPC treated the taxpayer as a 'firm', applied the due date applicable to firms, held the return to be belated, and denied the carry-forward of the loss.
- ∞ The dispute before the Tribunal was whether the taxpayer should instead be treated as a company for tax purposes, in which case the return would be treated as filed within time and the loss would be eligible for carry-forward.

Taxpayer's contentions

The taxpayer contended that, being a Limited Partnership incorporated under the Delaware Code with a separate legal identity, it qualified as a 'company' under the Act and was therefore entitled to the due date applicable to companies.

The taxpayer further submitted that the PAN status as a firm was merely a technical error, despite having furnished its Delaware incorporation documents.

Nonetheless, it argued that a foreign Limited Partnership cannot be regarded as a 'firm' under Sec. 2(23)(i), which is confined to firms governed by the Indian Partnership Act, 1932 and LLPs under the LLP Act, 2008.

Revenue's contentions

The Revenue contended that the taxpayer had itself declared its status as a Partnership Firm while applying for PAN, and the PAN was issued accordingly based on that declaration.

Since CPC processing under Sec. 143(1) is system-driven and limited to the information available in the PAN database, it correctly treated the taxpayer as a firm, applied the due date applicable to firms, and denied the carry-forward of loss.

The Revenue further argued that Sec. 143(1)(a) does not empower CPC to examine or re-determine the legal status of an taxpayer at the return-processing stage.

Tribunal's ruling

The key question before Tribunal was whether an entity registered outside India as limited partnership shall be treated as a corporate assessee in India or a partnership firm as per Income Tax Act, 1961.

Entity incorporated outside India cannot be treated as 'Firm' under the Act

As regards treating the foreign LP as a firm in India, the Tribunal concurred with the taxpayer that since the taxpayer is incorporated outside India, it is out of scope of 'firm' defined under the Act.

Foreign LP can be treated as 'Company' under the Act if taxed at entity level in home country

The Tribunal observed that a foreign LP can be treated as a "Company" in India only if it is taxed at the entity level in its home jurisdiction. Where such entity is fiscally transparent (i.e. income is not taxed in the hands of the LP instead it is taxed in the hands of partners), it may not qualify as a 'company' for India tax purposes.

Key Observations of Tribunal are summarised as under:

The Tribunal referred to *Consulting Engineer Corporation v. JDIT (OSD)*[6], and observed that *"as per provisions of the Income Tax Act, any body corporate, incorporated by or under the laws of a country outside India has to be treated as a foreign company …………for the purpose of determining tax status of the assessee."*

Notwithstanding this observation, the Tribunal considered it necessary to ascertain the taxpayer's legal identity under Article 3 and Article 4 India-USA Treaty, which requires such determination to be made based on the entity's formation and tax treatment in its country of incorporation, namely the United States.

- **Interpretation of the Term "Company" under Article 3 of the Treaty**

  The Tribunal examined Article 3(f) of the India-US Treaty, which defines a "company" as, a body corporate or any entity that is treated as a company or body corporate for tax purposes.

  Accordingly, a Limited Partnership (LP) established in USA would be treated as a 'Company' in India for income tax purpose, only if it satisfies the condition of being a "body corporate" for tax purposes.

- **Additional Test under Article 4(1)(b) to determine whether LP is 'body corporate'**

  Since the Treaty does not specifically clarify whether a US LP constitutes a "body corporate", the Tribunal applied an additional test derived from Article 4(1)(b) of the Treaty which embodies the principle that the tax treatment of partnerships and other fiscally transparent entities depends on where and in whose hands the income is ultimately subjected to tax.

  Under this test, the key consideration is whether the income is taxable:

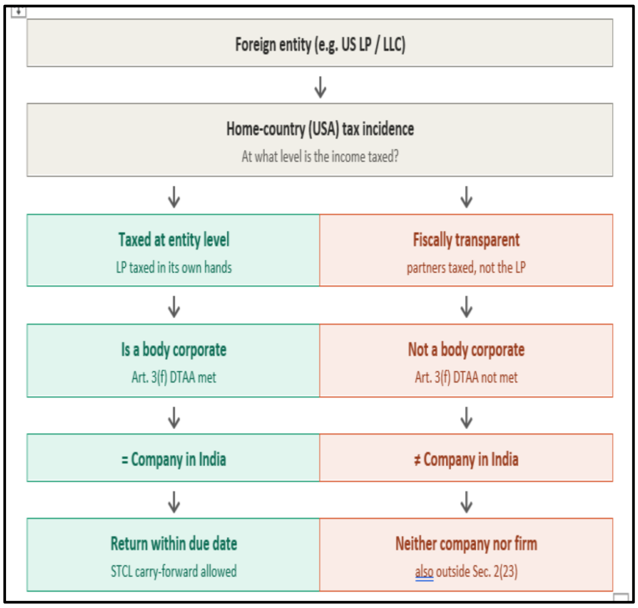
  - in the hands of the LP itself, or
  - in the hands of its partners

  Thus, applying the above test, if the LP is taxed as a separate entity in the home jurisdiction i.e. USA, it may qualify as a corporate entity for tax purposes in India.

  Conversely, where tax is imposed directly on the partners in respect of their share of the LP's income and not on the LP itself, the LP may not qualify as a "company" under Indian tax law.

[6] Consulting Engineer Corporation v. JDIT (OSD), Circle - 1(1), International Taxation, New Delhi [2016] 71 taxmann.com 284 (Delhi Trib)

The Tribunal's ratio on determining tax status of a US LP in India can be illustratively depicted as under:



While the Tribunal remanded the matter to AO for detailed examination of facts, it effectively held that the taxpayer's status must be determined with reference to both its legal form and its tax treatment in the jurisdiction where it is established and that if the taxpayer is able to demonstrate that it qualifies as a "company" under the Treaty, the return of income would be regarded as having been filed within the due date applicable to companies, and the consequent benefit of carrying forward the Short-Term Capital Loss (STCL) would be available in accordance with law.

Our Comments

This is a welcome decision where a US based LP was not treated as Firm in India solely based on PAN and the consequential carry-forward of the STCL linked to applicable due date for filing return was kept alive.

However, the more interesting aspect is the additional test that the Tribunal read into Article 3(f) via Article 4(1)(b) of the India-USA Treaty that - an LP would qualify as a "company" only if it is taxed at entity level in USA and may fail to so qualify if its income is taxed in the hands of its partners.

In practice, a US LP (like a US LLC electing partnership treatment) is ordinarily '*fiscally transparent*' i.e. taxed in the hands of its partners and not at the entity level.

On the Tribunal's own reasoning, such transparency could potentially disqualify the LP from being regarded as a 'company', while it would also not qualify as a 'firm' under Sec. 2(23) of the Act, leaving it in a grey area. This anomalous outcome would need to be examined and resolved in the set-aside proceedings.

ITAT Delhi | Sec 40(a)(i) disallowance on payments to non-residents restricted to 30% by applying the DTAA non-discrimination clause [7]

Background

Under Sec. 40(a)(i) of the Act, any interest, royalty, fees for technical services or other sum chargeable to tax, payable to a non-resident, on which tax is not deducted at source is disallowed in its entirety (i.e., 100%). However, for corresponding payments to residents, such 100% disallowance was introduced only in Finance (No. 2) Act, 2004 by insertion of Sec. 40(a)(ia).

By further contrast, under the said Sec. 40(a)(ia), as amended by the Finance (No.2) Act, 2014, the disallowance is now restricted to 30% of the sum on which tax is not deducted.

Accordingly, as of date, the disallowance in case of resident i.e. 30% and non-resident i.e. 100%, for the same default of non-deduction of TDS is unequal.

[7] GE India Industrial Private Limited v. ACIT [ITA Nos.3019 &3020/Del/2022] (Delhi Trib.)

The non-discrimination Article in India's tax treaties (e.g., Article 26(3) of the India-USA DTAA and Article 24(5) of the India-China DTAA) provides that disbursements paid by a resident of India to a non-resident shall, for determining taxable profits, be deductible under the 'same conditions' as if paid to a resident of India. Sec. 90(2) further provides that the beneficial provisions of a DTAA prevail over the Act.

In a recent ruling, the Delhi ITAT has ruled that applying a 100% disallowance under Sec. 40(a)(i) on payments made to US and Chinese residents, while limiting disallowance to 30% for similar payments to resident taxpayers, results in impermissible discrimination. Invoking the non-discrimination provisions of the tax treaties along with Sec. 90(2), the Tribunal held that the disallowance on such non-resident payments should also be restricted to 30%. Accordingly, the additional 70% disallowance made by the Revenue was deleted.

Brief Facts

- During the year, the taxpayer made certain payments to non-residents without deduction of tax at source, reported under clause 21(b)(i)A of the Tax Audit Report (TAR).
- Relying on the non-discrimination clause under Article 26(3) of the India-USA DTAA and Article 24(5) of the India-China DTAA, read with Sec. 90, the taxpayer *suo motu* restricted the disallowance under Sec. 40(a)(i) to 30%
- The Revenue enhanced the disallowance under Sec. 40(a)(i) from 30% to 100%, resulting in an additional disallowance. The CIT(A)/NFAC dismissed the taxpayer's appeal.

Taxpayer's contentions

- The taxpayer contended that the non-discrimination Article under the applicable tax treaties extends not only to the deductibility of expenses but also to the extent of disallowance.
- Therefore, imposing a 100% disallowance on payments to non-residents for TDS defaults, while restricting disallowance to 30% for similar payments to residents, amounts to discriminatory treatment.
- It was argued that the phrase "under the same conditions" requires parity both in the TDS compliance obligation and in the consequences of non-compliance, and that Sec. 90(2) mandates application of the more beneficial treaty provisions.
- The taxpayer further submitted that the issue was already settled by the Delhi ITAT in LinkedIn Technology Information v. PCIT[8], following the Delhi High Court's decision in CIT v. Herbalife International India (P.) Ltd[9], making the Revenue's action of enhancing the disallowance to 100% contrary to law and judicial discipline.

Tribunal's ruling

The Tribunal restricted the disallowance to 30% and deleted the additional disallowance.

Key observations made by the Tribunal are summarised below:

- **Discrimination persists despite parity of scope - Principles of Delhi High Court in Herbalife held relevant**

  The Tribunal relied on the decision in Herbalife (supra), which pertained to a period prior to 2004 when disallowance for non-deduction of TDS applied only to payments made to non-residents and not to residents.

[8] LinkedIn Technology Information v. PCIT [ITA No.2492/Del/2024] (Delhi Trib.)

[9] CIT v. Herbalife International India (P.) Ltd [384 ITR 276] (Delhi HC)

It held that, although Sec. 40(a)(ia) now extends disallowance to payments made to residents, the principle laid down by the Delhi High Court in Herbalife remains relevant. Specifically, Sec. 40(a)(i) continues to be violative of Article 26(3) of the India-USA DTAA to the extent that it imposes a 100% disallowance in the case of non-residents, as against only a 30% disallowance for residents for the same TDS default.

Thus, it was held that the scope of the non-discrimination Article is not restricted to whether an expense can be disallowed; it also covers quantum of disallowance.

- **Expression "same conditions" used in Article 26(3) of the Treaty also refers to parity in quantum of disallowance**

  The Tribunal observed that Article 26(3) of the DTAA requires payments to residents and non-residents to be subject to the "same conditions", which not only includes parity in TDS compliance condition for allowability of deduction for residents and non-residents, but also identical consequences for failure to deduct such TDS. This lack of parity in allowing the deduction is what brings about the discrimination.

  Post the 2014 amendment, even though both resident and non-resident payments are exposed to a TDS-linked disallowance, (so the existence of a disallowance is no longer discriminatory), the unequal percentages (i.e. 100% vs 30%) continue to produce prohibited discrimination on quantum.

- **DTAA takes precedence over the Act to the extent more beneficial**

  The Tribunal observed that under Sec. 90(2), DTAA provisions prevail over the Act to the extent they are more beneficial to the taxpayer. Accordingly, as per CBDT Circular No. 333 dt. 02-04-1982, where a DTAA *specifically provides a method or rule for taxation or computation of income, that treaty provision must be followed irrespective of the provision of the Income Tax Act………"*

  Thus, only where there is no specific provision in the DTAA, it is the Act that will govern taxation of income

  Therefore, to give effect to the Treaty's non-discrimination clause, disallowance for payments made to non-residents without tax deduction, must be restricted to 30%, in line with the treatment of similar payments to residents, notwithstanding the 100% disallowance prescribed under Sec. 40(a)(i) of the Act.

Our Comments

This decision affirms the position for non-resident taxpayers that the non-discrimination clause under caps on the quantum of a Sec. 40(a)(i) disallowance under the Act to 30% as applicable for residents, as against 100%, consequent to a TDS default.

Notably, Delhi High Court's *Herbalife International India (P.) Ltd.(supra)* was decided in a year when no disallowance applied to comparable resident payments. However, now, its extension to the post-2014 regime, where the dispute concerns only the quantum of disallowance (100% vs. 30%), is a more recent development endorsed in *LinkedIn Technology Information* (supra) and the present case, lending considerable support to the taxpayer's position, though pending an authoritative ruling from the Supreme Court.

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Glossary

Abbreviations	Term
Act	Income-tax Act, 1961
AO	Assessing Officer
CPC	Central Processing Unit
CIT(A)	Commissioner of Income Tax (Appeals)
DRP	Dispute Resolution Panel
DTAA	Double Tax Avoidance Agreement
ITAT	Income Tax Appellate Tribunal
Sec	Sec.

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