



INSIGHTS

Direct Tax

September 2026 Edition



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ITAT Mum | One-Time compensation for diminution in ESOP value, not taxable as perquisite or profit in lieu of salary, absent employment link ¹

Background

As per Sec. 17(2)(vi) of the Act, 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 a concessional rate, to the employee is taxable as a 'perquisite' under the head "Salaries". Explanation (c) to the said sub-clause values the security at its fair market value (FMV) on the date on which the option is exercised by the assessee, reduced by the amount recovered from the employee, while Explanation (a) extends the meaning of 'specified security' to securities offered under an employee stock option scheme.

Sec. 17(3) separately defines 'profits in lieu of salary' to include, inter alia, compensation received from an employer or former employer at or in connection with termination of employment or modification of its terms.

In continuation to the ongoing line of rulings on the issue of taxability of one time compensation paid by Flipkart, there is another addition on the issue through the recent ruling of the Mumbai ITAT, wherein it has been held that a one-time voluntary payment made by the ultimate parent to its option holders, consequent to a divestment, while the options remain unexercised and continue to be held by the employee, cannot be taxed as a perquisite under Sec. 17(2)(vi) or as profits in lieu of salary under 17(3), merely because tax was deducted under Sec. 192 and the amount was reported as salary in Form No. 16.

Brief Facts

- ∞ The taxpayer, an individual, was employed with Flipkart Internet Private Limited (FIPL). Flipkart Private Limited, Singapore (FPS), the ultimate holding company of FIPL, had granted him ESOPs under the Flipkart Stock Option Plan (FSOP), comprising both vested and unvested options.
- ∞ During the year, FPS divested/separated its PhonePe business from the Flipkart Group, resulting in a diminution in the value of the Flipkart stock options. The Board of FPS decided to make a one-time voluntary compensatory payment, stating that there was no legal or contractual right under the FSOP for such compensation.
- ∞ Accordingly, the taxpayer received the said compensation from FPS and FPS deducted TDS under Sec. 192 and reported the payment in Form No. 16 as "Salary".
- ∞ The taxpayer had neither paid any amount towards, nor exercised, the ESOPs, and continued to hold all of them after receiving the compensation.
- ∞ The taxpayer filed his return, disclosing the receipt as a 'capital receipt' not chargeable to tax.
- ∞ The AO held that the inclusive definition of 'perquisite' under Sec. 17(2), particularly Sec. 17(2)(vi), was wide enough to cover the payment even though the options were not exercised following Madras High Court in Nishithkumar Mukeshkumar Mehta², and made additions. CIT(A) confirmed the additions. In the alternative, the CIT(A) held the receipt taxable as 'profits in lieu of salary' under Sec. 17(3)(ii) r.w.s. 15.
- ∞ The taxpayer contended that since no ESOPs were exercised and no securities

¹ Ankit Jain v. DCIT [ITA 7979/MUM/2026] (Mum Trib.)

² Nishithkumar Mukeshkumar Mehta v. DCIT (TDS) [2024] 475 ITR 614 (Madras HC)

were allotted or transferred, the perquisite provisions under Sec. 17(2)(vi) were not applicable. It was further argued that the ESOPs were a capital asset and the compensation for diminution in their value constituted a capital receipt, not taxable as salary or any employment-linked benefit.

Tribunal's Ruling

The key issue before the Tribunal was - whether the one-time compensation received on account of diminution in value of unexercised ESOPs, when the options are being retained by the taxpayer, is taxable under the head "Salaries" as a perquisite or as profits in lieu of salary.

The Tribunal held that the issue stood substantially covered by the Delhi High Court's decision in *Sanjay Baweja*³, subsequently affirmed by the Karnataka High Court in *Manjeet Singh Chawla*⁴, both of which involved the same facts of PhonePe divestment compensation and held that a one-time voluntary payment for diminution in the value of unexercised ESOPs is not taxable as a perquisite under Sec. 17(2)(vi).

Key observations of the Tribunal are summarized as under:

∞ Proximate cause of compensation is decisive of its taxability, not the origin of the ESOPs

The Tribunal observed that the proximate cause of the payment was the PhonePe restructuring and resultant diminution in ESOP value, and not the taxpayer's employment.

Significantly, the ESOPs were neither exercised, cancelled, surrendered nor repurchased, and the taxpayer continued to hold the same rights after receiving the compensation. The Tribunal preferred the decision of the Division Bench ruling in

Sanjay Baweja over the contrary Single Judge decision in *Nishithkumar Mukeshkumar Mehta* to hold that the provisions of perquisite cannot apply to such one time compensation. The Tribunal's view also found support from the subsequent decision of the Karnataka High Court in *Manjeet Singh Chawla*, held on identical facts.

∞ Alternative argument of taxation as 'profits in lieu of salary' under Sec. 17(3)(ii), rejected

The Tribunal further rejected the Revenue's alternative plea of treating the compensation as profit in lieu of salary under Sec. 17(3)(ii), holding that a receipt judicially found to be unconnected with employment cannot be recharacterized as salary by invoking a different provision.

∞ Mere deduction of TDS does not determine the taxability of income

The Tribunal clarified that deduction of tax under Sec. 192 and reporting in Form 16 are not determinative of taxability. Deduction of tax at source is a machinery provision and the character assigned by the payer cannot create a charge of tax where the charging provisions, properly construed, do not bring the receipt to tax. The taxability of the amount has to be examined in accordance with the Act and the judicial interpretation applicable to the receipt.

Accordingly, the Tribunal directed deletion of the addition.

Our Comments

The Tribunal has anchored its decision on the "peculiar and undisputed facts" of no exercise, no cancellation, forfeiture or repurchase of ESOPs and a purely voluntary payment of one time compensation by the ultimate parent

³ Sanjay Baweja v. DCIT [2024] 474 ITR 376 (Delhi HC)

⁴ Manjeet Singh Chawla v. DCIT (TDS) [2025] 175 taxmann.com 778 (Karnataka HC)

employer. Hence, a payout accompanied by cancellation, surrender or buy-back of options, or a compensation contractually linked to employment, could invite a different outcome.

ITAT Bang | FCCD Issue proceeds not taxable under Sec.56(2)(viib) prior to conversion into equity ⁵

Background

Sec. 56(2)(viib) of the Act, as applicable for AY 2021-22, provides that where a closely held company receives, from a resident, any consideration for issue of shares which exceeds the fair market value of such shares determined under Rule 11UA, the excess is chargeable to tax under the head "Income from other sources". The provision is triggered specifically by consideration received "for issue of shares". Fully and Compulsorily Convertible Debentures (FCCDs), by contrast, are debentures at the time of issue and convert into equity shares only on a future date.

Under the RBI/FDI framework, debentures which are fully, compulsorily and mandatorily convertible are treated as equity instruments, and in *IFCI Ltd v. Sutanu Sinha*⁶, the Supreme Court, applying the 'repayment of principal' test in the context of a corporate insolvency resolution process, held that compulsorily convertible debentures which had already matured and automatically converted into equity were to be treated as equity and not debt.

In a recent ruling, the Bengaluru ITAT has held that receipt of consideration against FCCDs which had not yet matured or converted into equity cannot be regarded as consideration for "issue of shares" for the purposes of Sec. 56(2)(viib), since the issue of FCCDs and their subsequent conversion into equity are two

distinct events, and the character assigned to a convertible instrument under the RBI/FDI framework or the IBC cannot enlarge the charging language of the section, in the absence of an express provision.

Brief Facts

- ∞ The taxpayer, a closely held company, issued equity shares and FCCDs during the year.
- ∞ While the equity shares were internally valued under the DCF method at Rs. 352.60 per share, the FCCDs were separately valued by an IBBI-registered valuer under the DCF method at Rs. 703.89 per FCCD.
- ∞ The FCCDs were to mature in 2024 and retained their character as debentures until their future compulsory conversion into equity shares.
- ∞ The AO observed a significant disparity between the two DCF valuations prepared within a short span and rejected the higher FCCD valuation of ~ Rs. 704 as unreliable. Accordingly, the AO adopted Rs. 352.60 as the FMV.
- ∞ Proceeding on the basis that FCCDs are quasi-equity instruments equivalent to equity shares, the AO benchmarked the FCCD issue price against the FMV adopted for equity shares and treated the excess of about Rs. 351.40 per FCCD (Rs.704 – Rs. 352.60) as excess premium taxable under Sec. 56(2)(viib). The CIT(A) affirmed the addition without any independent examination.
- ∞ The taxpayer argued that FCCDs remain debt instruments until conversion and cannot be equated with equity shares for applying Sec. 56(2)(viib), which, during the relevant year, applied only to the "issue of shares". Reliance was placed on judicial precedents⁷

⁵ PH4 Food and Beverages Pvt Ltd [ITA No. 242/Bang/2026] (Bang Trib.)

⁶ IFCI Ltd v. Sutanu Sinha [Civil Appeal No.4929/2023]

⁷ CIT v. Bharat Engineering & Construction Co. [1972] 83 ITR 187 (SC); Wipro Ltd v. DCIT [62 taxmann.com 26] (Kar HC); SGM Webtech Private Limited v. Boulevard Projects Private Limited [(IB No. 967 (PB))] (NCLT Delhi)

recognizing the distinct character of convertible debentures and the principle that capital receipts are not taxable absent a specific charging provision.

Tribunal's ruling

The short controversy before the Tribunal was whether, for AY 2021-22, the consideration received on the issue of FCCDs could be brought to tax under Sec. 56(2)(viib) to the extent it exceeded the FMV of equity shares, by treating such FCCDs as being equivalent to equity shares prior to their conversion.

The Tribunal held that Sec. 56(2)(viib) could not be invoked in respect of consideration received on issuance of FCCDs, as the provision is triggered only where consideration is received for the issue of shares and contains no deeming fiction treating FCCDs as shares prior to conversion.

Key observations made by the Tribunal are summarized below:

∞ Issue of FCCDs and conversion into equity are distinct events

The Tribunal observed that the issuance of an FCCD and its subsequent conversion into equity are separate legal events. On the date of receipt of funds, the assessee had issued debt instruments carrying specified coupon obligations and not equity shares. The mere certainty of future conversion does not alter the character of the instrument for purposes of Sec. 56(2)(viib), particularly where the FCCDs remained outstanding and were not due for conversion until March 2024.

The Tribunal relied on Mumbai ITAT's decision in Rankin Infrastructure (P.) Ltd.⁸ wherein it was held that *"conversion of debentures into shares without fresh receipt of consideration could not by itself attract*

section 56(2)(viib)", to support this view. distinction.

∞ Regulatory characterisation cannot expand charging provision

The Tribunal further held that the statutory scope of Sec. 56(2)(viib) cannot be expanded by importing concepts from RBI/FDI or insolvency laws, or by reading convertible debentures into the provision. Consequently, the comparison of the FCCD issue price with the FMV of equity shares was held to be misconceived, rendering the valuation dispute largely academic and warranting deletion of the addition.

∞ A deeming provision cannot be expanded by interpretation

The Tribunal emphasized that accepting the Revenue's position would require reading the words "FCCDs" or "convertible securities" into Sec. 56(2)(viib), despite their absence from the statutory text. A deeming provision taxing an otherwise capital receipt must be strictly construed and cannot be extended to transactions not expressly covered by the legislature.

Thus, having held that issuance of FCCDs does not constitute an "issue of shares" for the purposes of Sec. 56(2)(viib), the Tribunal held that comparing the FCCD issue price with the FMV of equity shares was misconceived and rendered the valuation dispute academic.

Our Comments

The Tribunal's ruling is confined to the year of issuance of FCCDs and does not address the tax implications arising upon their subsequent conversion into equity shares. It nevertheless underscores the distinction between FCCDs and shares, while leaving open the issue of taxability on subsequent conversion. The ruling

⁸ DCIT v. Rankin Infrastructure (P.) Ltd. [2022] 142 taxmann.com 37 (Mum Trib.)

is also distinguishable from compulsorily convertible preference shares (CCPS), which are 'shares' from inception and therefore fall squarely within the provision.

As Sec. 56(2)(viib) stands omitted from AY 2025-26 onwards and finds no counterpart in the Income-tax Act, 2025, this ruling is of relevance primarily for years up to AY 2024-25 that continue to be governed by the 1961 Act. Nevertheless, the Tribunal's broader affirmation that a deeming provision taxing a capital receipt must be confined to its express statutory language and cannot be extended by implication remains a principle of wider significance.

Madras HC | Premature conversion of zero-coupon debentures into equity shares constitutes constructive receipt of the accrued interest embedded therein⁹

Background

Zero-coupon debentures carry no periodic interest; the return is built into the discount at which they are issued and is realised on redemption or settlement at a higher value. Interest on securities, where not chargeable as business income, is chargeable to tax under the head "Income from other sources" under Sec. 56 of the Act.

Conversion of debentures into shares of a company is excluded from the definition of 'transfer' for the purposes of capital gains by Sec. 47(x), and Sec. 49(2A) provides that the cost of acquisition of the resulting shares shall be deemed to be that part of the cost of the debenture, debenture-stock, bond or deposit certificate in relation to which the shares are acquired.

Under Sec. 263, the PCIT may revise an order of the AO where it is erroneous in so far as it is prejudicial to the interests of the Revenue, including where the AO has accepted a claim without necessary inquiry or proper application of mind to the applicable legal provisions.

In a recent ruling, the Madras High Court has upheld revision under Sec. 263 of a reassessment order that had accepted non-taxation of the interest component embedded in zero-coupon debentures which were prematurely converted into equity shares, holding that settlement of the accrued interest through allotment of valuable shares amounts to constructive receipt of income, notwithstanding the taxpayer's cash system of accounting and the exclusion of the conversion from 'transfer' under Sec. 47(x).

Brief Facts

- ∞ During F.Y. 2009-10, the taxpayer, a director and shareholder of SMJPL, was allotted zero-coupon convertible debentures of ₹2,000 each by the company. The debentures carried a 9 year tenure and were convertible/redeemable upon maturity with redemption value of Rs. 6,400/- per debenture.
- ∞ The company periodically amortised the discount in its books as interest expense.
- ∞ During FY 2012-13, SMJPL prematurely converted the debentures into equity shares and deducted TDS on the interest portion accruing for that specific financial year.
- ∞ The taxpayer offered only the current year's interest income to tax while claiming full TDS credit on the debentures. The AO accepted the taxpayer's explanation and completed reassessment without any addition.
- ∞ The PCIT invoked Sec. 263, holding that the AO had failed to examine the taxability of the accrued interest component of earlier years (FY 2009-10 to FY 2011-12) embedded in

⁹ Sanjay Saumya v. PCIT [T.C.A.No.151 of 2026] (Madras HC)

the debenture conversion. This view was subsequently affirmed by the ITAT, leading the taxpayer to file an appeal before the Madras High Court.

Taxpayer's contentions

- ∞ The taxpayer contended that, under the cash system of accounting, conversion of debentures into equity shares without any actual receipt of cash did not trigger taxable income.
- ∞ It was further argued that conversion is not regarded as a transfer under Sec. 47(x), and taxing the accrued interest component at the time of conversion could result in double taxation upon the eventual sale of the shares.

High Court's ruling

The key issue before the Court was - whether conversion of zero-coupon debentures into equity shares, exempt under Sec. 47(x), could nonetheless give rise to taxable interest income. The High Court dismissed the taxpayer's appeal and held that the accrued interest component embedded in the debentures did not lose its character as taxable income merely because it was settled through allotment of shares rather than cash.

Key observations made by the High Court are summarised below:

∞ Constructive receipt of accrued interest on conversion of debentures into shares

The interest component embedded in the zero-coupon debentures was discharged through allotment of equity shares on conversion. Receipt of shares carrying identifiable monetary value amounted to constructive receipt of the accrued interest and satisfaction of the company's obligation.

∞ Cash system cannot defer taxation of value received

The taxpayer's reliance on the cash system of accounting was rejected, as receipt of income is not confined to physical cash. Acceptance of equity shares in settlement of accrued interest constituted receipt of income, particularly when the taxpayer had also claimed credit for TDS deducted on such interest.

∞ Sec. 47(x) does not exempt interest income

While Sec. 47(x) excludes conversion of debentures into shares from the ambit of "transfer" for capital gains purposes, it does not alter the character or taxability of the interest component embedded in the transaction, which remains assessable under the Act.

∞ No double taxation on subsequent sale

The High Court rejected the double-taxation argument of the taxpayer, observing that once the interest component is taxed on conversion, the same forms part of the cost base of the shares acquired, thereby avoiding double taxation upon the eventual sale of such shares.

Our Comments

Essentially, the High Court held that on premature conversion of zero-coupon debentures into equity shares, the accrued interest embedded in the value of the shares allotted is taxable as interest income under the head Income from other sources in the year of conversion, on the principle of constructive receipt. This holds good irrespective of the taxpayer following the cash system of accounting and notwithstanding the exclusion of the conversion from 'transfer' under Sec. 47(x).

As regards, the High Court's denial of exemption under Sec. 47(x), it appears that in the present case, from the terms of the debenture and the conduct of the parties involved, there was admittedly interest income accrued to the assessee and accordingly the Court denied applying the provisions of Sec. 47(x) while concluding taxability of income in the nature of interest.

Interestingly, the Court's observation that at the time of sale of shares, the taxed interest will form part of the cost of the shares is not expressly supported by Sec. 49(2A), which deems the cost of the shares to be the corresponding cost of the debentures, without specifically providing for inclusion of any accrued interest taxed earlier. The logic behind such observation would be that the deeming

provision under Sec. 49(2A) would apply to the principal component of the zero-coupon debentures, which are simply converted into shares. As against this, the interest component receivable in lieu of shares, forming part of the redemption value, is akin to a case of purchase of shares by the assessee and accordingly the said interest amount would be allowable as cost of the shares when they are subsequently sold.

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Glossary

Abbreviations	Term
Act	Income-tax Act, 1961
AO	Assessing Officer
CIT(A)	Commissioner of Income Tax (Appeal)
ITAT	Income Tax Appellate Tribunal
IBC	Insolvency and Bankruptcy Code
PCIT	Principal Commissioner of Income Tax
Sec	Section

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