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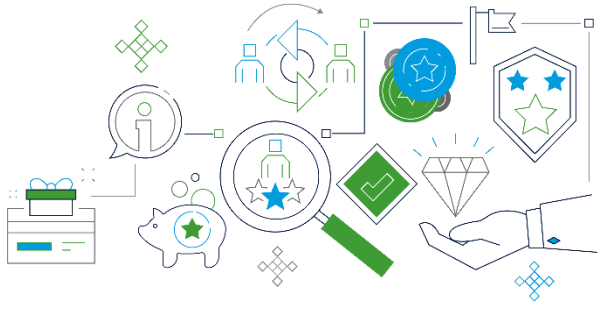
RSM India Newsflash – Bangalore Tribunal clarifies tax treatment of repurchase of unexercised stock options; Taxable as capital gains, not salary

Newsflash

Bangalore Tribunal clarifies tax treatment of repurchase of unexercised stock options; Taxable as capital gains, not salary

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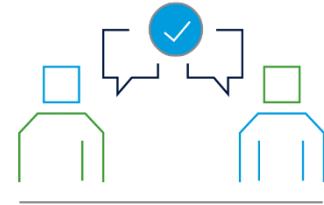
1.0 Background

- 1.1 The tax treatment of employee stock options requires careful consideration where the options have vested but have not yet been exercised. In such cases, a question may arise whether the amount received on repurchase of the options by the employer should be taxed as salary or as capital gains. This depends on the stage at which the transaction takes place and whether the employee has actually exercised the options and received the underlying shares. The recent ITAT Bangalore ruling examines this issue in the context of vested but unexercised stock options.
 
- 1.2 In the case of ***Pramod Kumar Jain vs. Deputy Commissioner of Income Tax - Circle 3(3)(1)***¹, the ITAT Bangalore reversed the lower authorities' decisions by holding that the consideration received following repurchase of vested but unexercised stock options cannot be taxed as a salary perquisite under section 17(2)(vi) of the Income Tax Act, 1961 ('the Act') and was instead taxable as capital gains.
- 1.3 Pramod Kumar Jain ('the Appellant') was an employee of Flipkart Internet Private Limited ('FIPL'), an Indian company, and a step-down wholly owned subsidiary of Flipkart Private Limited, Singapore ('FKS').
- 1.4 During employment with FIPL, the Appellant was granted 40,536 stock options by FKS under the Flipkart Stock Option Plan, 2012 ('FSOP 2012'). During the relevant year, FKS repurchased 2,653 stock options from the Appellant (which were vested but not exercised) for a total consideration of approximately Rs. 2.34 crores. While filing his income-tax return, the Appellant offered the resulting gains as Long-Term Capital Gains (LTCG) rather than salary income.
- 1.5 The primary issue was whether consideration received upon repurchase of vested but unexercised stock options constitutes a perquisite liable to be taxed as salary income or whether it represents gains arising from transfer of a capital asset.

¹ ITA No. 3034/BANG/2025 (AY 2020-21)

2.0 Contentions of the Appellant

- 2.1 The Appellant contended that the repurchase consideration was received from FKS, an overseas ultimate parent entity with whom the Appellant had no employer-employee relationship. Accordingly, the receipt could not be taxed under the head 'Income from Salaries'.
- 2.2 The Appellant submitted that the stock options had never been exercised and no shares had been allotted to him. Therefore, the conditions prescribed under section 17(2)(vi) of the Act were not satisfied and the consideration received upon repurchase of the vested stock options could not be taxed as a perquisite under the head 'Salaries'.
- 2.3 It was further submitted that the vested stock options represented a right to subscribe to the underlying shares at a future date and, therefore, constituted a 'capital asset' under section 2(14) of the Act. Accordingly, the gains arising upon repurchase of such options were taxable under the head 'Capital Gains'.
- 2.4 The Appellant also contended that the tax treatment mentioned in the Letter of Offer for Repurchase was merely indicative and did not determine the exact nature of receipt. Similarly, reporting of the amount in Form 16 and deduction of TDS under section 192 of the Act could not determine its taxability in the hands of the Appellant.
- 2.5 Relying on the decision of the Hon'ble Delhi High Court in **Sanjay Baweja vs. DCIT**², the Appellant contended that the consideration received upon repurchase of the vested stock options was taxable under the head 'Capital Gains'.



3.0 Contentions of the Revenue

- 3.1 The Revenue contended that stock options were granted to the Appellant in relation to his employment with FIPL under a scheme applicable to the Flipkart group. Hence, the consideration received upon repurchase of the vested stock options is related to his employment and was taxable under the head 'Salaries'.
- 3.2 The Revenue pointed out that FIPL had explicitly categorised the amount as a perquisite under section 17(2) in Form 16 and subjected it to TDS under section 192 of the Act. Further, the Letter of Offer for Repurchase clearly stated that the consideration would be taxable under the head 'Income from Salaries'. The lower authorities had accordingly held that the stock options fell within the purview of 'specified securities' under section 17(2)(vi) of the Act and the consideration received upon their repurchase was taxable as a perquisite.
- 3.3 The Revenue also placed reliance on the judgment of the Hon'ble Madras High Court in **Nishithkumar Mukeshkumar Mehta vs. DCIT**³, wherein compensation received by a Flipkart employee from FKS in connection with the divestment of FKS's stake in PhonePe was held to be taxable under the head 'Salaries'.



² 163 taxmann.com 116 (Delhi)

³ [2024] 165 taxmann.com 386 (Madras)

4.0 Decision by the Hon'ble Tribunal ('ITAT Bangalore')

- 4.1 The ITAT observed that, on a plain reading of section 17(2)(vi) of the Act, an employee's stock option, by itself, is not a 'specified security'. It is only the underlying security offered under the scheme that qualifies as 'specified security' once it is allotted or transferred to the employee free of cost or at a concessional rate.
- 4.2 The Tribunal noted that Explanation (c) to section 17(2)(vi) of the Act mandates that the perquisite value be determined with reference to the fair market value ('FMV') of the specified security on the date on which the option is exercised. Relying on the principle laid down by the Hon'ble Supreme Court in *CIT vs. B.C. Srinivasa Setty*⁴, the ITAT held that where the computation provisions cannot apply, the corresponding charging provision cannot be invoked. Since the options had never been exercised and no shares had been allotted, no specified security came into existence and, consequently, no perquisite could be computed under section 17(2)(vi) of the Act.
- 4.3 The Tribunal observed that section 2(14) of the Act defines a 'capital asset' to include property of any kind and Explanation 1(e) to section 2(42A) of the Act recognises 'right to subscribe to a financial asset' as a capital asset. Relying on the decision of the Hon'ble Supreme Court in *Miss Dhun Dadabhoy Kapadia vs. CIT*⁵ and the jurisdictional Hon'ble Karnataka High Court in *Chittharanjan A. Dasannacharya vs. CIT*⁶, the ITAT held that the vested stock options, being a right to subscribe to the underlying shares, constituted a 'capital asset'. Their repurchase by FKS amounted to 'transfer' under section 2(47) of the Act and the resulting gains were taxable as LTCG under section 45 of the Act.
- 4.4 The ITAT noted that the tax treatment set out in Schedule 4 of the Letter of Offer for Repurchase was merely indicative and did not constitute tax advice. The Tribunal held that the arrangement between the parties could not determine the tax liability of the Appellant, which had to be ascertained in accordance with the law.
- 4.5 On the issue of Form 16 and TDS, the Tribunal referred to Article 265 of the Constitution of India and observed that no tax could be collected except by authority of law. It further held that TDS is merely an advance tax-collection mechanism and, therefore, reporting of the amount as a perquisite in Form 16 and deduction of TDS under section 192 of the Act could not determine the final taxability of the receipt in the hands of the Appellant.
- 4.6 The ITAT distinguished the decision of the Hon'ble Madras High Court in *Nishithkumar Mukeshkumar Mehta vs. DCIT*, wherein the employee had retained the stock options and received compensation in connection with the divestment of FKS's stake in PhonePe. On the other hand, the present case involved the actual repurchase of vested but unexercised stock options by FKS. Further, the Tribunal held that the Madras High Court ruling was not applicable to the facts of the present case. As such, it was held that the gains arising upon repurchase of the vested but unexercised stock options were taxable under the head 'Capital

⁴ [1981] 128 ITR 294 (SC)

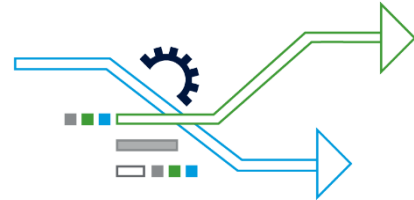
⁵ [1967] 63 ITR 651 (SC)

⁶ [2020] 429 ITR 570 (Karnataka)

Gains' rather than as salary income. Accordingly, the grounds relating to the tax treatment of the repurchase consideration were allowed in favour of the Appellant.

5.0 Our Comments

- 5.1 The decision provides clarity on the stage at which section 17(2)(vi) may apply to employee stock options. The Tribunal held that, in the absence of exercise of the stock options and consequent allotment or transfer of the underlying specified security, no perquisite could be computed under section 17(2)(vi). Section 2(14) of the Act defines the term "capital asset" to mean property of any kind held by the assessee. Further, while defining the term "short-term capital asset" in section 2(42A) of the Act, clause (e) of Explanation-1 to the said section treats the right to subscribe to any financial asset as a capital asset. Accordingly, on the facts of the present case, the gains arising upon repurchase of the vested but unexercised stock options were taxable under the head 'Capital Gains' rather than as salary income.
- 5.2 The ruling provides useful guidance for employees and employers dealing with vested but unexercised stock options. However, the tax treatment would depend on the specific terms of the stock option plan, the stage at which the transaction occurs and whether the payment represents consideration for transfer of the option/right or is in the nature of employment-related compensation. Accordingly, companies may need to evaluate their TDS position under section 192 in cases involving cross-border repurchase of employee stock options.
- 5.3 The decision is fact-specific and should be distinguished from situations where an employee receives compensation or another corporate payout while continuing to retain the stock options. The actual repurchase/transfer of the vested but unexercised stock options, as against mere payment of compensation while retaining the options, was an important distinguishing factor in the Tribunal's conclusion. Further, the probability of the department litigating it with higher authorities cannot be completely ruled out.



For further information please contact:

RSM Astute Consulting Pvt. Ltd.

9th Floor, Maker Chambers VI, Nariman Point, Mumbai – 400021

3rd Floor, Technopolis Knowledge Park, A Wing, MIDC, Andheri East, Mumbai - 400093

T: (91-22) 6108 5555/ 6121 4444

F: (91-22) 2287 5771

E: emails@rsmindia.in **W:** www.rsmindia.in

Offices: Mumbai, New Delhi - NCR, Chennai, Kolkata, Bengaluru, Navi Mumbai, Surat, Hyderabad, Ahmedabad, Pune, Gandhidham, Jaipur and Vijayanagar.



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This Newsflash highlights provides an overview on the Bangalore Tribunal ruling that consideration received on the repurchase of vested but unexercised employee stock options is taxable as capital gains and not as salary/perquisites, since the options were never exercised and no shares were allotted. It may be noted that nothing contained in this Newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain thereof and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this Newsflash.

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