Tax Flash News

3 August 2026

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Repurchase of vested but unexercised stock options results in capital gains and not salary taxation

Executive summary

In the case of *Pramod Kumar Jain*,[1] the Bangalore Bench of the Income-tax Appellate Tribunal ('Bangalore Tribunal') held that the repurchase of vested options constituted transfer of a capital asset, resulting in "capital gains", and not a perquisite chargeable to tax under the head "salaries."

The Bangalore Tribunal relied on the Karnataka High Court's decision in the case of *Chittharanjan A. Dasannacharya* and held that a vested stock option is a right to acquire shares in future and therefore qualifies as a capital asset. It also distinguished the Madras High Court's decision in the case of *Nishithkumar Mukeshkumar Mehta* on the ground that in that case the employee continued to retain all stock options even after the receipt of compensation.

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[1] *Pramod Kumar Jain* v. *DCIT* (ITA No. 3034/2025)

Facts of the case

The taxpayer was an employee of an Indian company ('ICo').

ICo was a step-down subsidiary of a foreign company ('FCo').

During the course of employment, the taxpayer was granted options under the stock option scheme of FCo. In FY 2019-20, a portion of these stock options were repurchased by FCo and the consideration received was offered to tax as capital gains by the taxpayer.

The Revenue reopened the assessment under the Income-tax Act, 1961 ('the 1961 Act')[2] on the ground that the amount should have been taxed as salary/ perquisite under section 17(2)(vi) of the 1961 Act and not as capital gains.

The Revenue, after considering the submissions of the taxpayer, passed an order that the consideration received towards repurchase of the options was taxable as salary income and could not be treated as capital gains (taxable at the lower rate of 20 per cent).

[2] Sections 147 and 148

Relevant provisions

Section 17(2)(vi) of the 1961 Act includes within the definition of "perquisite", the value of any specified security or sweat equity shares allotted or transferred by the employer (or former employer) to the employee, either free of cost or at a concessional rate.

Explanation (c) to section 17(2)(vi) provides that the perquisite value is the fair market value of the security/ share on the date of exercise as reduced by the amount actually paid by, or recovered from, the employee.

Revenue’s contentions

The stock options were issued on account of taxpayer’s employment with ICo. Accordingly, the benefit had a direct nexus with employment and constituted an employment-related benefit.

Relied on Form 16 issued by ICo, which reflected the amount received on repurchase of stock options as a taxable perquisite under section 17(2) of the 1961 Act and tax was withheld thereon treating the same as salary income.

Referred to the "Letters of Offer for Repurchase of Vested Options" issued by FCo. These documents indicated that amounts received pursuant to the repurchase were taxable under the head “salaries”.

Tribunal’s decision

The Bangalore Tribunal ruled in favour of the taxpayer and held that the repurchase of vested options constituted transfer of a capital asset, resulting in “capital gains”, and not a “perquisite” chargeable to tax under the head “salaries.”

Key observations of the Tribunal included:

Taxability under section 17(2)(vi) arises only upon exercise of stock options

A reading of section 17(2)(vi), particularly Explanation (c) to the section, makes it clear that valuation of the perquisite is linked to the date on which the option is exercised. Therefore, the charging mechanism itself contemplates a situation where the shares are allotted or transferred upon exercise of options. Accordingly, until the exercise takes place, an employee merely holds an option or right to acquire shares and not the underlying ‘specified security’ itself.

No taxable perquisite in the absence of exercise

Since the stock options were only granted and vested in the taxpayer, but never exercised by him, no shares were allotted and no ‘specified security’ came into existence. Consequently, the pre-conditions for taxation under section 17(2)(vi) were not satisfied.

Reliance on the Supreme Court ruling in *B.C. Srinivasa Setty*

Relied on the principle laid down by the Supreme Court in *B.C. Srinivasa Setty*,[3] namely that the charging provisions and computation provisions of

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[3] *CIT* v. *B.C. Srinivasa Setty* [1981] 128 ITR 294 (Supreme Court)

a tax statute constitute an integrated code. If the computation mechanism fails, the charging provision itself cannot operate.

Applying this principle, the Tribunal observed that section 17(2)(vi) contains a specific computation mechanism based on the fair market value of the security on the date of exercise. In the absence of exercise, no specified security came into existence, and no valuation mechanism could operate. Therefore, the charging provisions relating to perquisites also failed.

Vested stock options constitute capital assets

Relied on *Dhun Dadabhoy Kapadia*[4] and *Chittharanjan A. Dasannacharya*[5] rulings wherein it was held that a right to subscribe for shares is a capital asset. A vested stock option is a right to acquire shares in future and therefore qualifies as a capital asset under the 1961 Act.[6]

Repurchase qualifies as a 'transfer'

The repurchase of the vested options by FCo resulted in 'transfer' under the 1961 Act.[7]

Form 16 and TDS cannot determine taxability

The Revenue's reliance on the tax disclosure in the repurchase offer letters and the reporting in Form 16/ Form 26AS was misplaced. The Tribunal observed that taxability must be determined in accordance with the law and not by the payer's characterisation of payment. TDS deduction and reporting are merely tax collection mechanisms and do not conclusively determine the recipient's tax liability.

Distinguished Madras High Court ruling

The Tribunal distinguished the single-judge decision of the Madras High Court in the case of *Nishithkumar Mukeshkumar Mehta*,[8] *inter alia*, on the ground that in that case the employee continued to retain all stock options even after the receipt of compensation. However, in the instant case, some of the stock options were repurchased by FCo on payment of consideration.

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[4] *Miss Dhun Dadabhoy Kapadia* v. *CIT* [1967] 63 ITR 651 (Supreme Court)
[5] *Chittharanjan A. Dasannacharya* v. *CIT* [2020] 429 ITR 570 (Karnataka)
[6] Section 2(14)
[7] Section 2(47)
[8] *Nishithkumar Mukeshkumar Mehta* v. *DCIT* [2024] 165 taxmann.com 386 (Madras)

Our comments

The ruling is significant for stock options liquidity and buy-back arrangements commonly implemented by start-ups and multinational groups. The Tribunal has held that consideration received on the repurchase of vested but unexercised stock options is taxable as capital gains rather than as salary, depending on the facts and terms of the plan. However, considering the divergent judicial views on the taxation of stock option-related receipts and compensation payments, it remains to be seen how higher judicial forums will reconcile the differing judicial views.

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