



Fringe Benefit Tax (FBT) abolished - Employee Stock Options or any other equity oriented incentive scheme (ESOPs)¹ in the perquisite net

The Finance Bill 2009, has proposed to abolish FBT (*For complete details on the India Budget 2009, please refer to the Budget 2009 Highlights*). As a consequence of abolishing FBT, ESOPs which were until now being taxed under the FBT regime, will now be taxed as perquisite in the hands of employees. Further, no concessional treatment has been proposed in line with the tax treatment of ESOPs prior to FBT regime.

As the ESOP tax regime has changed numerous times, we have outlined the legislative history on the tax treatment in Annexure.

This Flash News summarises the proposed changes made by the Finance (No. 2) Bill, 2009, with respect to taxability of ESOPs as perquisites.

¹ With effect from 1 April 2009, 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 taxpayer would be taxable as perquisite.

"Specified security" and "sweat equity shares" have also been defined to mean as under:

(i) "Specified security" means the securities as defined in section 2 (h) of the Securities Contracts (Regulation) Act, 1956, i.e. shares, debentures, stocks, derivatives etc. and includes employees' stock option.

(ii) "sweat equity shares" means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

In this Flash News the above have been collectively referred to as ESOPs.

Perquisite taxation on ESOPs

The taxability of ESOPs under the FBT regime received a lot of criticism from the corporate sector as well as tax experts. This was on account of the fact that it required the employer to pay tax on a benefit clearly identifiable and accruing to the employee. Also the value of the benefit had to be computed in relation to a future valuation of the share, determined by market, rather than a value controlled by the employer. Further, the FBT paid by the employer was not a tax deductible expense leading to a much higher post-tax expenditure.

Taking these issues into consideration, the Finance Minister (FM) has proposed to abolish FBT and again bring ESOPs within the ambit of the perquisite tax regime. It is now proposed to tax ESOPs as perquisite in the hands of employees on the date of *exercise*. The benefit would be computed as the difference between the Fair Market Value (FMV) of the shares on the date of exercising the options and the exercise price. It would be interesting to note that the FM has not reverted back to the pre-FBT regime of ESOPs being exempt from perquisite tax if they qualified as per the erstwhile Central Government (ESOP Guidelines). Instead, the proposed treatment is identical to the ESOP tax regime during the period 1 April 1999 to 31 March 2000.

The amended provisions will be effective from 1 April 2009. Any exercise of options on or after 1 April 2009 will be now be taxed as perquisite in the hands of the employees.

Further, it is proposed that for the purpose of computing capital gains, FMV on date of exercise would form the cost basis.

The relevant provisions, as proposed, are briefly reiterated hereunder:

- Any benefit from ESOPs would be taxed as perquisite in the hands of the employees on the date of *exercise*, at the difference between the FMV of the shares on the date of exercising the options and the exercise price.
- Any subsequent sale of shares by employees would trigger capital gains tax liability in the hands of the employee. For the purpose of computing capital gains FMV on date of exercise would form the cost basis.

The holding period of shares shall be reckoned from the date of allotment/ transfer of the security. If such shares are listed on the Indian stock exchange, long term capital gains tax liability will be 'Nil'.

The FM, by proposing to abolish FBT, has addressed the concerns of the corporate sector. However, there are still some open issues/ concerns on the practical implementation of the proposed new provisions, such as:

- Whether advance FBT already paid by companies in relation to shares allotted on or after 1 April 2009 be refunded or adjusted against their corporate tax liability? Or will the companies be allowed to adjust the same against withholding tax obligations on perquisite value of ESOPs exercised on or after 1 April 2009?

- Would the valuation rules be identical to the valuation rules applicable for valuing ESOPs under the FBT regime or would there be new rules prescribed?
- Where foreign companies have employees based in India and consequently perquisite value on ESOPs, there ought to be exclusion for proportionate value of benefit attributable to the employees' services rendered outside India *vice versa*. There was a specific clarification on proportionate taxability of benefits under the FBT regime. However, there is no specific provision in this regard.
- Where an employees' cash salary is lower than the tax liability on the perquisite value determined on exercise of options under ESOPs, the employers may not be able to withhold tax to discharge the tax obligations. In such a situation, would the company be empowered to dispose certain shares of the employee to meet the tax obligation (this may also have capital gains implications in the hands of the employee)?

Our comments

To conclude, while the FBT abolition is a welcome step and has brought back the cheer to the corporates, it does not provide any concessional tax treatment to the employees. The employees will first have to bear the tax burden without realising any benefit (which will happen only on sale of the shares).

In light of the open issues, additional clarifications may still be required.

Annexure - Legislative history

- Upto the financial year ending March 1999, there were no specific provisions for taxing ESOPs. ESOPs were generally taxed as a perquisite in the hands of the employees as the difference between the FMV of the stock on the date of **vesting** of the options and the exercise price in the hands of the employees. There was another school of thought that it should be taxed on exercise and not on the date of vesting.
- During the period 1 April 1999 to 31 March 2000, benefit from stock options were taxed as perquisite in the hands of the employees on the date of **exercise**, at the difference between the FMV of the shares on the date of exercising the options and the exercise price.
- The position in law during the period 1 April 2001 to 31 March 2007, was as under:
 - any benefit provided by a company free of cost, or at a concessional rate to its employees by way of **allotment** of securities under the ESOPs, which were offered to the employees, in accordance with the Guidelines issued in this behalf by the ESOP Guidelines, were exempt from taxation at the time of allotment². **Accordingly, the benefit arising to employees under an ESOP, which was in accordance with the ESOP Guidelines, was taxable only at the time of sale of the shares.** Hence, no tax liability arose to the employee, either on vesting or exercise of options or on allotment of the shares.
 - If the benefit under an ESOP did not qualify for favourable tax treatment, the same was taxable as a perquisite and the difference between the FMV on the date of vesting / exercise and the exercise price, was taxable as ‘income from salary’. The point at which the benefit was taxable, i.e. whether at the time of vesting or exercise of the option to purchase the shares, has been a matter of debate as there was no specific legal provision in this regard. One school of thought, based on legal principles, suggested that the benefit was taxable on the date of vesting of the options (in our opinion this was a better view). There was however a counterview that such benefits should be taxed when the options are exercised, in light of the earlier provisions (since deleted) for taxation of such benefits at the time of exercise.

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² Proviso to section 17(2)(iii) of the Income-tax Act, 1961.

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For further information about KPMG in India and our services, please contact:

Bangalore

Maruthi Infotech Centre, 11-12/1
Inner Ring Road
Koramangala, Bangalore 560071
Phone: + 91 80 3980 6000 Fax: +91 80 3980 6999

Chennai

KPMG House
No.10, Mahatma Gandhi Road,
Nungambakkam High Road,
Chennai 600034
Phone: +91 44 39145000 Fax: +91 44 39145999

Delhi

DLF Cyber City, Building no. 10, Block B, Phase II
Gurgaon, Haryana 122 002
Phone: +91 124 307 4000 Fax: +91 124 254 9195

Hyderabad

KPMG, 8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad - 500 034
Phone: +91 40 66305000/23350060 Fax: + 91 40 6630 5299

Kolkata

KPMG Infinity Benchmark
Plot No. G-1, 10th floor Block - EP & GP,
Sector – V, Salt Lake City
Kolkata - 700091
Phone: +91 33 4403 4000 Fax: +91 33 4403 4199

Mumbai

KPMG House, Kamala Mills Compound, 448 Senapati Bapat Marg
Lower Parel, Mumbai 400 013
Phone: +91 22 39896000 Fax: + 91 22 39836000

Pune

703, 7th Floor Godrej Castlemaine, Next to Ruby Hall Clinic,
Bund Garden Road, Pune 411001
Phone: +91 20 30585764/65 Fax: +91 20 3058 5775