

**F. No. 142/25/2007-TPL
Government of India
Ministry of Finance
Department of Revenue
(Central Board of Direct Taxes)**

New Delhi, the 20th December, 2007

**To
All Chief Commissioners of Income-tax/
Directors General of Income-tax**

Sub:- Explanatory circular on Fringe Benefit Tax arising on allotment or transfer of specified securities or sweat equity shares.

In terms of the provisions of Chapter XII-H of the Income-tax Act (hereinafter referred to as "Act"), an employer, being a company, is liable to pay Fringe Benefit Tax (FBT) in respect of the fringe benefits provided or deemed to have been provided by it to its employees, directly or indirectly, during the previous year.

With a view to bring grant of stock options by employers to employees within the purview of FBT, Finance Act, 2007 has inserted a new clause (d) in sub-section (1) of section 115WB. The salient features of this provision are:-

- (i) FBT shall apply in all cases where any specified security or sweat equity shares has been allotted or transferred by the employer to his employees;
- (ii) FBT shall be payable in the previous year in which such allotment or transfer has taken place;
- (iii) the provisions of this new clause shall apply even if the allotment or transfer is directly or indirectly;
- (iv) the provisions of this new clause shall apply even if the allotment or transfer is free of cost or at concessional rate;
- (v) the provisions of this new clause shall apply even if the allotment or transfer is to current or former employee or employees;
- (vi) the provisions of this new clause shall apply in cases where the allotment or transfer is on or after 1st day of April, 2007.

The expressions "specified security" and "sweat equity shares" have also been defined. The value of fringe benefit is subjected to FBT at the prevailing rate, which is currently 30% plus surcharge plus education cess.

2. Method of computation of the value of the fringe benefit

Under the existing provisions contained in section 115WC, the method of computation of the value of fringe benefits referred to in section 115WB has been provided. A new clause (ba) in sub-section (1) of the said section 115WC has been inserted to provide for computation of fringe benefit related to allotment or transfer of specified security or sweat equity shares by employers to employees.

It has been provided that the value of fringe benefit in such cases shall be determined in accordance with the formula –

$$A - B$$

Where, A = the Fair Market Value (FMV) of the specified security or sweat equity shares on the date of vesting of the option; and

B = the amount, if any, actually paid by, or recovered from the employee;

The expression “fair market value” has been defined to mean the value determined in accordance with the method as may be prescribed by the Board.

“Option” has been defined to mean a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price.

The Central Board of Direct Taxes (CBDT) vide notification S.O. number 1805(E) dated 23rd October, 2007 has inserted Rule 40C in the income-tax Rules; which has prescribed the method for determination of fair market value of specified security or sweat equity share, being a share in the company. Salient features of this rule are:

- (i) In a case where, on the date of the vesting of the option, the share in the company is listed on a recognized stock exchange, the fair market value shall be the average of the opening price and closing price of the share on that date on the said stock exchange;
- (ii) If on the date of vesting of the option, the share is listed on more than one recognized stock exchanges, the fair market value shall be the average of opening price and closing price of the share on the recognised stock exchange which records the highest volume of trading in the share;
- (iii) If on the date of vesting of the option, there is no trading in the share on any recognized stock exchange, the fair market value shall be,-

- (a) the closing price of the share on any recognised stock exchange on a date closest to the date of vesting of the option and immediately preceding such date; or
- (b) the closing price of the share on a recognised stock exchange, which records the highest volume of trading in such share, if the closing price, as on the date closest to the date of vesting of the option and immediately preceding such date, is recorded on more than one recognized stock exchange.
- (iv) In a case where, on the date of vesting of the option, the share in the company is not listed on a recognized stock exchange, the fair market value shall be such value of the share in the company, as determined by a Category 1 Merchant Banker registered with the Security and Exchange Board of India, on the specified date.
- (v) The specified date has been defined as to mean,-
 - (i) the date of vesting of the option; or
 - (ii) any date earlier than the date of the vesting of the option, not being a date which is more than 180 days earlier than the date of the vesting.

3. Determination of the cost of acquisition for capital gains purposes

Consequent to insertion of clause (ba) in sub-section (1) of section 115WC providing for the valuation of fringe benefits referred to in clause (d) of sub-section (1) of section 115WB, a new sub-section (2AB) has been inserted in section 49.

This new sub-section provide that the cost of acquisition of specified security or sweat equity shares shall be the fair market value which has been taken into account while computing the value of fringe benefit under the new clause (ba) of sub-section (1) of section 115WC.

4. Determination of the period of holding

A new sub-clause (hb) has also been inserted in clause (i) of Explanation 1 to clause (42A) of section 2. This new sub-clause provide that the period of holding in case of such specified security or sweat equity shares, in the hand of the employee, shall be reckoned from the date of allotment or transfer of such security or shares.

5. Recovery of FBT by the employer from its employee

A new section 115WK has also been inserted enabling the employer to recover the fringe benefit tax from the employee in respect of specified security or sweat equity shares, if such security or shares are transferred or allotted to the employee on or after 1st April, 2007.

It has been prescribed that the employer can vary the agreement or scheme under which such specified security or sweat equity shares has been allotted or transferred. The agreement or scheme can be varied with a purpose to recover from the employee the fringe benefit tax to the extent to which such employer is liable to pay the fringe benefit tax in relation to the allotment or transfer of such specified security or sweat equity shares to such employee.

6. Illustration

The above amendments are explained with the help of an illustration.

Illustration: A company 'X' grants option to its employee 'R' on 1st April, 2004 to apply for 100 shares of the company at a pre-determined price of Rs. 50/- per share with date of vesting of the option being 1st April, 2006 and exercise period being 1st April, 2006 to 31st March, 2010.

Employee 'R' exercises his option on 31st March, 2007 and shares are allotted/transferred to him on 3rd April, 2007. On 25th October, 2007 these shares are sold for Rs. 200/- each. On the date of vesting of the option, fair market value of the share was Rs. 80/- per share. The tax implication of above situation will be as under:-

Since shares are allotted or transferred on or after 1st April, 2007, provision of fringe benefit tax are attracted. Fringe benefit with respect to employee 'R' is $(Rs. 80 - Rs. 50) \times 100 = Rs. 3,000/-$.

Company 'X' will pay fringe benefit tax on Rs. 3,000/-.

Cost of acquisition in the hand of employee 'R' = Rs. 80/- per share

Capital gain = $(Rs. 200 - Rs. 80) \times 100 = Rs. 12,000/-$

Period of holding = 3rd April, 2007 to 25th October, 2007 i.e., less than 12 months. Hence, the amount of Rs. 12,000/- will be charged to short term capital gain.

7. Frequently Asked Questions

A number of issues have been raised by trade and industry at different fora after the presentation of the Finance Bill, 2007, after its enactment and also after the notification of Rule 40C. The questions and answers in the following section seek to clarify these issues:

- 1. Whether a foreign company is liable to pay FBT on shares allotted or transferred to the employees of its Indian subsidiary?**

Answer: In terms of the provisions of Chapter XII-H of the Act, an employer, being a company, is liable to pay FBT in respect of the fringe benefits provided or deemed to have been provided by it to its employees, directly or indirectly, during the previous year. Since the shares are allotted or transferred to employees of the Indian subsidiary, by virtue of their employment with the subsidiary company, the liability to pay fringe benefit tax on such shares vests upon the Indian subsidiary and not on the foreign company.

2. Whether charge back of costs by the foreign company to the Indian subsidiary is relevant to determine the obligation of the Indian company to pay FBT?

Answer: As stated in answer No.1, the Indian subsidiary is liable to fringe benefit tax irrespective of whether or not there is a charge back of cost by the foreign holding company.

3. Will FBT apply in case of employees of the Indian subsidiary for shares awarded by the foreign holding company if the employees of the Indian subsidiary are allotted or transferred shares while outside India?

Answer: In the answer to Question No.20 of CBDT Circular No. 8/2005 dt. 29.8.2005, it has been clarified that an employer is liable to fringe benefit tax on the value of fringe benefits provided or deemed to have been provided to employees based in India. Therefore, an Indian subsidiary would be liable to pay FBT in respect of the value of the shares allotted or transferred by the foreign holding company if the employee was based in India at any time during the period beginning with the grant of the option and ending with the date of vesting of such option (hereafter such period is referred to as 'grant period'), irrespective of the place of location of the employee at the time of allotment or transfer of such shares.

4. How will the value of fringe benefit be determined in case where the employee was based in India only for a part of the grant period?

Answer: In a case where the employee was based in India only for a part of grant period, a proportionate amount of the value of the fringe benefit will be liable to FBT. The proportionate amount shall be determined by applying to the value of the fringe benefit, the proportion which the length of the period of stay in India by the employee during the grant period bears to the length of the grant period.

(The value of fringe benefit means the fair market value of the specified security or sweat equity shares, on the date on which the option vests with the employee, as reduced by the amount actually

paid by, or recovered from, the employee in respect of such shares.)

5. **Whether a foreign company is liable to fringe benefit tax in respect of shares allotted or transferred to an employee who is deputed to work in India in the year of such allotment or transfer?**

Answer: A foreign company is liable to FBT in respect of shares allotted or transferred to its employee who is based in India. However, in such cases only a proportionate amount of the value of the fringe benefit will be liable to FBT. The proportionate value shall be determined by applying to the value of the fringe benefit, the proportion which the length of the period of stay in India by the employee during the grant period bears to the length of the grant period.

(The value of fringe benefit means the fair market value of the specified security or sweat equity shares, on the date on which the option vests with the employee, as reduced by the amount actually paid by, or recovered from, the employee in respect of such shares.)

6. **What will be the cost of acquisition of shares, referred to in question nos 4 and 5, where only a proportionate value of fringe benefit has been subjected to FBT?**

Answer:- In accordance with section 49(2AB) of the Act, the cost of acquisition of such shares shall be the fair market value on the date on which the option vests with the employee. The calculation of fringe benefit for the purpose of determining FBT does not change this value. Hence, the subsequent calculation of reducing such fair market value by the amount actually paid by or recovered from the employee as well as the calculation of proportionate value in certain cases, referred to in Question No.4 & 5 above, will not change the cost of acquisition.

7. **Where the benefit on account of shares allotted or transferred under Employee Stock Option Plans (ESOPs) is taxed in the hands of the employees in different countries, would the employer still be liable to FBT? If yes, can the employer claim credit for payment of tax by the employee in other countries?**

Answer: Employer will be liable to FBT in India irrespective of whether employees have been charged to tax in different countries or not. An employer cannot claim any credit in India against its FBT liability for taxes paid by employees in other countries.

8. **Where FBT, on account of shares allotted or transferred under ESOPs, has been paid by the employer in respect of an employee based in India and subsequently recovered from**

him, can such employee claim credit in a foreign country for this FBT paid by the employer in India?

Answer: Ordinarily, the employee is liable to tax in respect of fringe benefits received by him from his employer. However, the taxation of fringe benefits in the hands of the employee raises several problems. Accordingly, it was decided to introduce FBT as a surrogate tax on employer in respect of the fringe benefits provided or deemed to have been provided by it to its employees during the previous year. This being so, in a case where FBT, on account of share allotted or transferred ESOPs, has been paid by the employer in respect of an employee based in India and subsequently recovered from him; the FBT is effectively paid by the employee in respect of fringe benefits enjoyed by him. Therefore, such employee can claim credit, in a foreign country, for the FBT, on account of shares allotted or transferred under ESOPs, paid by the employer in India.

9. Whether the benefits arising on account of shares allotted or transferred under ESOPs can be taxed as a perquisite under section 17 of the Act instead of being taxed as fringe benefit under Chapter XII-H of the said Act, at the option of the employer?

Answer: Any fringe benefit liable to be taxed in the hands of the employer under Chapter XII-H of the Act cannot be taxed in the hands of the employee as a perquisite under section 17 of the said Act. Therefore, an employer does not have an option to tax the benefit arising on account of shares allotted or transferred under ESOPs as perquisite which otherwise is to be taxed as fringe benefit.

10. Whether there will be any FBT liability in a case where the FMV on the date of vesting is less than the price paid by the employee to the employer for allotment or transfer of shares?

Answer: No. FBT would not be payable in such cases.

11. What will be the valuation methodology for foreign companies if the shares are not listed in a recognized stock exchange in India but are listed on any globally recognised stock exchange?

Answer: If the shares are not listed in a recognized stock exchange in India, the shares will be treated as unlisted. Accordingly, such shares will have to be valued by category 1 Merchant Banker registered with Securities and Exchange Board of India. However, if the shares are listed in any globally recognised stock exchange, the merchant banker shall use the listed price as one of the basis for valuation and recommend the best value.

12. **Whether an independent valuation carried by any foreign merchant banker/other experts as recognized for the purposes of valuation in the foreign country be treated as sufficient compliance for the purposes of valuation of fringe benefit arising on account of allotment or transfer of shares under ESOPs of an unlisted foreign company or is it mandatory that the merchant banker should be registered with the Securities and Exchange Board of India.**

Answer: For the purposes of valuation of fringe benefit arising on account of allotment or transfer of shares under ESOPs of an unlisted foreign company, it is mandatory for the valuer to be a category I Merchant Banker registered with the Securities and Exchange Board of India.

13. **When there exists different methods for valuing FMV for unlisted companies, which method should be used by the merchant bankers to determine the FMV?**

Answer: The Merchant Banker should determine the FMV on the basis of alternative methods and recommend the most appropriate value.

14. **What is the significance of specified date? Whether the valuation is to be made on a specified date or specified security or sweat equity share is to be valued as on the specified date?**

Answer: The process of valuation may be carried out by the merchant banker at any time before or after the date of vesting of the option, but the specified security or the sweat equity share is required to be valued as on the specified date.

15. **What is the FMV that a company should adopt if the shares have been valued by more than one merchant banker or by one merchant banker on more than one occasion?**

Answer: The valuation which value the specified security or sweat equity share on the specified date, which is closest to the date of the vesting of the option, should be adopted, if the shares have been valued by more than one Merchant Banker or by one Merchant Banker on more than one occasion.

16. **Whether the fringe benefit arising on account of shares allotted or transferred under an ESOP is allowed as deduction in calculating the taxable income of the employer company?**

Answer: In case where the employer purchases the shares and then subsequently transfers such shares to its employees, the expenditure so incurred is allowable as deduction in computing the taxable income of the employer company. However, if the shares are allotted to the employees from the share capital of the

company, no deduction is allowable in computing the taxable income of the company since no expenditure has been incurred by it.

17. Whether ESOPs issued to non-executive directors or non-employees liable to FBT?

Answer: Benefit arising out of ESOPs issued to non-employees will not be liable to FBT. However, in such cases, the taxability of such benefits in the hands of the non-employees will be determined in accordance with the existing law.

18. Which method, first-in-first-out (FIFO) or last-in-first-out (LIFO) shall be followed in case there are multiple date of vesting for different number of shares. For example if the dates of vesting are:

31 Mar 06 - 300 options – FMV Rs. 8 per share (one share per option)

31 Mar 07 - 300 options – FMV Rs. 9 per share (one share per option) and the employee is allotted 500 shares as on 30 September 2007, how will FBT be calculated?

Answer: In such cases, the First-in-First-Out (FIFO) method shall be followed. Hence, the FBT shall be calculated with respect to 300 shares at FMV of Rs 8 per share and 200 shares at FMV of Rs 9 per shares.

19. Whether it is binding upon the Assessing Officer to accept the valuation made by the merchant banker?

Answer: It is binding upon the Assessing Officer to accept the valuation made by the Merchant Banker unless the valuation by such banker is perverse.

20. How would the recovery of FBT be treated in the hands of the employer?

Answer: Since FBT is not an allowable deduction in computation of the income of the employer, any recovery of FBT will not be treated as income in his hands.

21. What should be the mechanism and timing of recovery of FBT?

Answer: The law does not provide for any specific mechanism or timing of recovery of FBT.

22. Is it lawful for the employer to recover FBT with respect to ESOPs granted prior to April 1, 2007?

Answer: It would be lawful for the employer to recover FBT with respect to ESOPs granted prior to April 1, 2007, but allotted or transferred to the employee after such date.

23. What will be the date of allotment of an Employee Stock Option?

Answer: The date of allotment of an Employee Stock Option shall be the date on which the underlying asset is allotted or transferred to the employee

24. Whether the FBT recovered from the employee would form the cost basis for employee for calculating Capital Gain on subsequent sale of shares?

Answer: No. The recovery of FBT from the employee by the employer will not change the cost of acquisition of the shares in the hand of the employee.

25. Will Rule 40C of Income-tax Rules, shall also apply in a case where shares are allotted or transferred to an employee under “Employee Stock Purchase Plan”, or “Employee Stock Option Scheme”, or “Employee Stock Ownership Plan”, or “Employee Stock Purchase Scheme”, or “Employee Stock Option Scheme” or “Employee Appreciation Rights or Plans”?

Answer: Rule 40C shall apply in all cases where specified security or sweat equity shares, being shares in a company, are allotted or transferred to an employee under any scheme or plan or otherwise. For the purpose of this circular an Employees’ Stock Option Plan shall include all such schemes or plans, etc.

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