HR & Tax Alert

Ernst & Young
Quality In Everything We Do

The Government of India issues an explanatory circular on fringe benefit tax on ESOPs

December 2007

Executive Summary

The Indian Government has issued an explanatory circular (Circular No 9/2007 dated 20th December 2007) to clarify a number of issues with respect to the applicability of fringe benefit tax ('FBT') on employee share based payments (generically referred to hereinafter as "ESOPs").

The circular clarifies that an Indian subsidiary is liable for FBT even if the ESOPs are granted/shares are issued to its employees by the foreign parent company regardless of whether there is a cross-charge or not.

In case of internationally mobile employees, the circular makes it clear that FBT will be levied on the value of Fringe Benefits proportionate to the number of days the employee has stayed in India during the Grant Period (period from date of Grant to date of Vesting) regardless of whether the employee is in India or not at the time of allotment/ transfer of shares.

With respect to arriving at the Fair Market Value ("FMV") of the equity shares, the circular makes it mandatory for foreign companies to use a registered Category 1 Merchant Banker even if their shares are listed on an overseas stock exchange.

In case FBT is recovered from the employees, the circular clarifies that the recovered amount will not be taxable in the hands of the employer. It also indicates that a recovery is tantamount to the employee paying the tax and hence should be treated as such for foreign tax credit purpose.

The full text of the circular can be downloaded from

http://www.incometaxindia.gov.in/archive/CircularNo9_21122007.pdf

Background

The Finance Act, 2007 has included employee share based payments within the ambit of FBT with effect from April 1, 2007. As per the legislation, an employer is required to pay FBT @ 30% (plus applicable surcharge and cess) on transfer/allotment of specified security or sweat equity shares free of cost or at a concessional rate to its employees (including former employees). The FBT shall be payable on the Value of Fringe Benefit i.e. the difference between the Fair Market Value ("FMV") on the date of vesting of options as reduced by the amount, if any, paid by the employee at the time of allotment/transfer of shares to the employees.

In October 2007, the Government of India introduced Rule 40C for determination of FMV on equity shares on the date of vesting of options. As per the Rule, the employer is required to obtain a valuation certificate from a Category 1 Merchant Banker registered with the Securities and Exchange Board of India ("SEBI") for shares not listed on a recognized stock exchange in India (kindly refer our earlier Tax Alert of October 2007 on this subject).

Clarifications given in the circular

The Government of India, through the Central Board of Direct Taxes (CBDT), has issued a specific circular (Circular 9/2007) to clarify its position on some of the issues relating to FBT on ESOPs. The key clarifications provided in the circular under the heading "Frequently Asked Questions" are summarized and analyzed below:

1) An Indian subsidiary is liable to pay FBT on ESOPs granted to its employees by the foreign holding company. This will apply irrespective of whether or not there is a charge back of cost by the foreign holding company. FBT is payable upon allotment/transfer of specified securities, directly or indirectly, to employees (including former employees) either free of cost or at a concessional price. [Q1, Q2]

2) In the case of internationally mobile employees, FBT is applicable only if the employee was based in India at anytime during the Grant Period. "Grant Period" has been defined as the period from date of Grant of option to date of Vesting of option. If an employee is based in India only for a portion of the "Grant Period", FBT will be applicable on a proportionate basis in the ratio of days of stay in India to the length of the Grant Period. The location of employee on the date of allotment / transfer of specified securities is of no relevance. [Q3, Q4, Q5]

Comments

(a) The clarification creates trailing liabilities in case of employees who have stayed in India for any time during the Grant Period but have left India prior to the date of allotment/ transfer of specified securities. Such employees (including former employees) will have to be tracked and FBT calculated and paid as and when allotment/transfer of the securities takes place.

(b) On the other hand, in case of ESOPs, if the options have vested prior to the employee's arrival to India, no FBT will arise upon exercise of the options even if the exercise happens while the employee is in India.

(c) Although FBT is prima-facie an employer tax, by permitting pro-ration on the above principles, the tax authorities have implicitly recognized that ESOPs and other share based payments are earned over the period of vesting (referred to in the circular as "Grant Period") which is in alignment to the OECD's position on cross-border income tax issues on ESOPs.

Illustration: A company grants 100 options to an employee on 1st June 2005 while he is in USA. The exercise price is Rs 25 per share. The options vest equally over 2 years i.e. 50% on 31st May 2006 and 50% on 31st May 2007. The employee is seconded to India on 1st January 2007 for 2 years assignment. On 30th June 2007, he exercises all 100 options by paying the exercise price. The FMV on 31st May 2006 and 31st May 2007 is Rs 60 per share and Rs 80 per share respectively. The FBT liability will be calculated as follows:

- 50 options have vested prior to the employee having spent any day in India. Hence no FBT is payable upon exercise of these 50 options.

- Balance 50 options have vested while the employee was in India. The Value of Fringe Benefits with respect to such options = (Rs 80 – Rs 25) * **50** ~~100~~ = Rs.**2750** ~~5500~~

Since the employee has been in India for part of the Grant Period, the taxable Value of Fringe Benefit shall be computed as follows:

Taxable Value of Fringe Benefits:

= Value of Fringe Benefits * $\frac{\text{No. of days in India}}{\text{Days in Grant Period}}$

= Rs **2750** ~~5500~~* 151 / 730

= Rs **569** ~~1138~~

* *The circular has not specified whether the period has to be counted in days or months or years. However, it would be appropriate (and more precise) to make the apportionment on the basis of complete days with even part days spent in India being counted as a full day.*

3) The cost of acquisition (cost base) of shares at the time of sale will be the FMV on the date of vesting of option. The proportionate FBT calculation in case of mobile employees will not affect this position. If any recovery is made from the employee, such recovery cannot form part of the cost of acquisition. [Q6, Q24]

4) The circular admits that fringe benefits should ordinarily be taxed in the hands of the employee and FBT is a "surrogate tax" on the employer. Hence where a recovery is made from employee on account of FBT, as per the circular, FBT is "effectively paid by the employee" and hence should be regarded as employee tax for claiming tax credit in the foreign country. [Q8]

Comments

Where the employee is a resident of a foreign country, the foreign country will allow credit for foreign tax based on the bilateral tax treaty or its domestic tax law. In the absence of any enabling provision under either of these two regulations, it is doubtful that the circular by itself would allow a sustainable foreign tax credit claim.

5) The employer will not able to claim any credit against the FBT for the foreign taxes, if any, paid by the employees in other countries. [Q7]

Comments

(a) Where the employee is resident of India and is paying personal income tax in the foreign country on account of ESOPs, the circular does not permit the employer to reduce its FBT liability to the extent of foreign taxes paid by the employee on the doubly taxed income. This position is not in harmony with CBDT's own admission in the circular that the FBT is a "surrogate tax".

(b) The circular is silent on availability of foreign tax credit in India in employee's hands in the given situation if the employer is recovering FBT from the employee.

6) A certificate from a Category 1 Merchant Banker registered with Securities and Exchange Board of India (SEBI) needs to be obtained for determining the FMV on the date of vesting of options for shares not listed on a recognized stock exchange in India. This position shall apply even if the shares are listed on a globally recognized stock exchange outside India. However, the Merchant Banker can use the overseas listed price as one of the basis for valuation and recommend the best value. [Q11]

6.1 Valuation from any other Valuer/Merchant Banker other than SEBI registered Category 1 Merchant Banker will not be recognized [Q12];

6.2 The valuation provided by the Merchant Banker will ordinarily be binding upon the tax officer unless the valuation is "perverse" [Q19].

Comments

What will constitute "perverse" has not been specified. By giving this leeway to the tax officer, the binding nature of the valuation report has been diluted to an extent. However, the onus of proving that the valuation is perverse will lie upon the tax officer.

7) Where the employer purchases the shares and then subsequently transfers such shares to its employees, then the expenditure so incurred will be allowed as a deduction in calculating the taxable income of the employer company. However, no deduction will be allowed when the company allots shares to employees by issuing fresh shares out of its share capital [Q16].

Comments

(a) The circular has not explicitly dealt with a situation where the Indian company gets a chargeback from the foreign parent on account of ESOPs to the Indian employees. However, following the analogy of Q16, if the foreign company has purchased the shares, any chargeback equal to the expenditure incurred by the foreign company on purchase of the said shares should be eligible for deduction.

(b) The circular ignores the Guidance Note issued by the Institute of Chartered Accountants of India (ICAI) on accounting of employee share based payments. This indicates that any deduction claimed by companies based on amounts expensed in line with the Guidance Note is likely to be challenged.

8) FBT is not payable on shares issued to non-executive directors and other non-employees. But, the benefit will be subject to personal income tax in the hands of such individuals. [Q17]

9) FBT recovery from the employee will not be treated as taxable income in the hands of the employer. [Q20]

10) The valuation rules (Rule 40C) will apply in all cases where equity shares in a company are allotted or transferred to employees. [Q25]

Comments

(a) In many places, the term ESOPs has been used in a generic sense to cover all kinds of share based payments.

(b) Rule 40C relates only to equity shares. Till date, no valuation rules have been issued with respect to any other type of security. For example, if an employee is issued tradable stock options and he, instead of exercising, sells the stock options, there is currently no guidance available on how this transaction can be brought to tax.

(c) It may be reasonable to presume that Phantom Shares or Stock Appreciation Rights will not be subject to FBT since there is no allotment or transfer of shares. Gains arising from such instruments could be taxable in the hands of the employee as "salary".

Conclusion

The circular is a commendable attempt to remove many ambiguities that have prevailed in the tax payer's minds ever since share based payments have been brought under the ambit of FBT. While some issues still remain unresolved, the circular provides adequate guidance to enable companies to take decisions and compute their FBT liability for the year. Overall, the circular is largely beneficial in nature and will be welcomed by the companies.

Since FBT is triggered on allotment/transfer of shares, one needs to exercise caution in determining the exact date of allotment/transfer of shares. For instance, if an employee exercises options on 31st March 2007 but if the shares are allotted on 4th April 2008, then FBT should be payable in the financial year 2008-09 and not in 2007-08.

Next Steps

With the clarifications provided in the circular, the companies will be in a better position to assess their FBT liability and remit the taxes before the last installment which is due on March 15, 2008. The circular is generally binding only on the revenue department and not on tax payers. Hence, tax payers can take a different position and go through the appellate process in case of dispute. Companies who have globally mobile employees (inbound or outbound) will need to keep full tabs on the movement of such employees so as to comply with the FBT requirements. Ernst & Young India will continue its dialogue with the CBDT to obtain guidance on some of the yet unresolved issues.

For further information, please contact your local Ernst & Young Global Tax Advisory Services or Human Capital – Global Mobility professional, or in our India office:

Amitabh Singh	Delhi	Tel: +91 12 4464 4720	E-mail: amitabh.singh@in.ey.com
Sanjay Grover	Mumbai	Tel: +91 22 6665 5450	E-mail: sanjay.grover@in.ey.com
Sonu Soni Iyer	Delhi	Tel: +91 12 4464 4480	E-mail: sonu.iyer@in.ey.com
Rajesh S	Bangalore	Tel: +91 80 4027 5447	E-mail: rajesh.s@in.ey.com

© 2007 Ernst & Young
All Rights Reserved
Ernst & Young is
a registered trademark

This Alert provides certain general information existing as at the time of production and does not express the views of Ernst & Young. This Alert does not purport to identify all the developments in the tax and regulatory domain. To the best of our knowledge, the information contained in it is correct as on the date of this Alert. As with all media reportings, you will appreciate that the responsibility of Ernst & Young is limited to bringing out a synopsis, and Ernst & Young has not separately checked on the veracity of the information reported. Ernst & Young does not undertake any legal liability for any of its contents. The information provided is not, nor is it intended to be an advice on any matter and should not be relied on as such. Professional advice should be sought before taking action on any of the information contained in it. Without prior permission of Ernst & Young, this Alert may not be quoted in whole or in part or otherwise referred to in any documents.

Contact us at ey.taxalert@in.ey.com

For internal use / private circulation only