Analysis of Taxation of Employee Stock Option Plan (ESOP)

Facts of the case:

Mr. X has joined a company A Ltd. on January 01, 2001. He has been given options to take shares of A Ltd which as follows:

Particulars	Scenario I (before April 01, 2009)	Scenario II (on/after April 01, 2009)
Date of joining	April 01, 2001	April 01, 2001
Date of granting an option	April 01, 2002	April 01, 2002
Grant period	April 01, 2002 to March 31, 2011	April 01, 2002 to March 31, 2011
Date of vesting of the option	April 01, 2005	April 01, 2005
Fair market value on date of vesting	Rs. 150 per share	Rs. 150 per share
Date on which Mr. X has exercised the option by applying for 100 shares.	March 20, 2008	March 20, 2011
Fair market value on date of exercising	Rs. 200 per share	Rs. 250 per share
Date of allotment	April 01, 2008	April 01, 2011
Exercise price	Rs. 10 per share	Rs. 10 per share
Date of sale	September 01, 2011	September 01, 2011
Sale price	Rs. 350 per share	Rs. 350 per share

A. Scenario I (before April 01, 2009)

I. Relevant Statutory Provisions- Finance Act, 2007:

A. Charge of fringe benefit tax, Sec.115WA:

a. In addition to the income-tax charged under Income Act 1961, there shall be charged for every assessment year commencing on or after the 1st day of April, 2006, additional income-tax (in this Act referred to as "fringe benefit tax") in respect of the fringe benefits provided or deemed to have been provided by an employer to his employees during the previous year at the rate of thirty per cent on the value of such fringe benefits.

b. Notwithstanding that no income-tax is payable by an employer on his total income computed in accordance with the provisions of this Act, the tax on fringe benefits shall be payable by such employer.

B. Salary, Perquisite and Profits in lieu of salary defined, Section 17(2)*(iii):* It is provided that nothing contained in this sub-clause {Section 17(2)*(iii)*} shall apply to the value of any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants directly or indirectly under any Employees Stock Option Plan or Scheme of the company offered to such employees in accordance with the guidelines issued in this behalf by the Central Government.

Note: In the year 2009, Section 17(2)*(iii)* was omitted & Fringe benefit tax was abolished in respect to ESOP's.

C. Value of fringe benefits, **Section 115WC(1)*(ba)*, Finance Act, 2007, w.e.f. April 01, 2008:** The value of fringe benefit will be 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 security or shares.

Taxable amount of fringe benefit = FMV (on the date of vesting) – Exercise price.

Note: In the year 2009, Section 17(2)*(vi)* has been inserted by Finance Act, 2009 for treatment of ESOP.

- Fair Market Value (FMV) shall be determined in the following manner:
  - 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;
  - 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;
  - 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,-
    - 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
    - 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.
  - 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.
    - The specified date has been defined as to mean,-
      a. The date of vesting of the option; or
      b. 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.

D. Cost with reference to certain modes of acquisition, Section 49(2AB), Finance Act, 2007, w.e.f. April 01, 2008: Where the capital gain arises from the transfer of specified security or sweat equity shares, the cost of acquisition of such security or shares shall be the fair market value which has been taken into account while computing the value of fringe benefits under Sec. 115WC (1)*(ba)*, i.e. FMV will be on date of vesting.

II. Understanding Section 17(2)*(iii)*, Section 115WC(1)(ba) & Section 49(2AB) and its applicability for the given case:

1. As shares are allotted on April 01, 2008 (i.e. before April 01, 2009), Fringe Benefit Tax (FBT) is applicable in the hands of the employer. The value of fringe benefit will be Rs. 14,000 (i.e. Rs. 150, being FMV on date of vesting – Rs. 10, being exercise price x 100 shares).

2. The cost of acquisition in hand of assessee ('x') for the purpose of determining capital gain at time of transfer of shares will be Rs. 150 per share (i.e. being FMV on date of vesting). Therefore the capital gains will be Rs. 20,000 (i.e. Rs. 350, being sale price – Rs. 150, being fair market value on date of vesting x 100 shares).

III. Opinion:

1. The employer has to pay Fringe Benefit Tax (FBT) on the fringe benefit aggregating to the amount of Rs. 14,000.
2. If assessee ('x') subsequently sells the shares, has pay capital gain tax @ 20% on Rs. 20,000, which aggregates to Rs. 4,000.

B. Scenario II (on/after April 01, 2009)

I. Relevant Statutory Provisions- Finance Act, 2009.

A. **Section 17(2)*(iii)* was omitted & Section 17(2)*(vi)* has been inserted for treatment of Employee Stock Option Plan (ESOP) by Finance Act, 2009:** The taxable perquisite will be the difference between the fair market value (FMV) of the shares on the date of exercise of the options less the exercise price:-

Taxable amount = Fair market value – Exercise price.

Perquisite shall be taxable in the hands of the employee only when shares are allotted to him under ESOPs. The perquisite is not taxable when employee exercises his option to ESOPs. However, the perquisite shall be worked out on the basis of Fair Market Value of ESOPs on the date when employee exercises his option to ESOPs.

- Fair Market Value (FMV) shall be determined in the following manner:

  - Where shares in the company are listed on a single recognized stock exchange – FMV shall be the average of opening and closing price of shares on the date of exercise of option. However, if on the date of exercise of option there is no trading in shares, the FMV shall be the closing price of the share on a date immediately preceding such date of exercise of option.
  - Where shares in the company are listed on more than one recognized stock exchange – FMV shall be the average of opening and closing price of the share on the date of exercise of option on a recognized stock exchange which records the highest volume of trading in the shares. However, if on the date of exercise of option there is no trading in shares, the FMV shall be the closing price of the share on a date immediately preceding such date of exercise of option.
  - Where shares in the company are not listed on a recognized stock exchange – FMV shall be such value of the share in the company as determined by a category I merchant banker registered with SEBI on the specified date. Specified date means the date of exercise of option or any date earlier than the date of exercise of option (not more than 180 days earlier than the date of exercise of option).

  Note: Before April 01, 2009 it was an exempt perquisite for employee & Fringe Benefit Tax was paid by the employer on the fringe benefits under Sec. 115WC (1)*(ba)* which was inserted by the Finance Act, 2007.

B. Cost with reference to certain modes of acquisition, Section 49(2AA), Finance Act, 2009, w.e.f. April 01, 2010: Where the capital gain arises from the transfer of specified security or sweat equity shares referred under Sec. 17(2)*(vi)*, the cost of acquisition of such security or shares shall be the fair market value which has been taken into account for the purposes of the said sub-clause {Sec. 17(2)*(vi)*}, i.e. FMV will be on date of exercising the options.

Note: If the shares are allotted before April 01, 2009, the cost of acquisition of such security or shares shall be the FMV taken for calculating fringe benefit under Section 115WC (1)*(ba)* introduced by the Finance Act, 2007 (i.e. the FMV as on date of vesting).

II. Understanding of above Sec. 17(2) (*vi*) & its applicability for the given case:

1. Perquisite will be taxable in the hands of assessee ('x') as shares are allotted on April 01, 2011 (i.e. after April 01, 2009). The value of perquisite will be Rs. 24,000 [i.e. Rs. 250, being FMV on date of exercising – Rs. 10, being exercise price x 100 shares].

2. The cost of acquisition in hand of assessee ('x') for the purpose of determining capital gain at time of transfer of shares will be Rs. 250 per share (i.e. being FMV on date of exercising). Therefore the capital gains will be Rs. 10,000 (i.e. Rs. 350, being sale price – Rs. 250, being FMV on date of exercising x 100 shares).

III. Opinion:

1. The assessee ('x') has to pay tax on the perquisite of amount Rs. 24,000 according to slab rates for the F.Y 2011-12.
2. If assessee ('x') subsequently sells the shares, he has to pay capital gain tax @ 20% on Rs. 10,000, which aggregates to Rs. 2,000.