

# Tax Hotline

December 24, 2007

## CLARITY AT CHRISTMAS – GOVERNMENT CLARIFIES APPLICABILITY OF FRINGE BENEFIT TAX ON EMPLOYEE STOCK OPTIONS

The Indian Finance Act, 2007 introduced provisions to expand the ambit of Fringe Benefit Tax ("FBT") to include the grant of Employee Stock Options ("ESOPs") by employers to employees. By virtue of these provisions, an employer is liable to pay FBT at the rate of 30% (excluding surcharge and education cess) at the time of transfer of the security to the employees on the difference between the fair value of the security at the time of vesting and the amount paid by the employee. The Government also introduced a provision making it lawful for an employer to pass on the fringe benefit tax liability to its employee. In addition, the Government recently introduced the **valuation norms** for valuation of securities, which require foreign companies and Indian unlisted companies to appoint a merchant banker for valuation of these securities.

While the newly inserted provisions created havoc within the corporate community, they also gave rise to a lot of ambiguity on the actual application of the new law. However, on December 20, 2007 the Central Board of Direct Taxes ("CBDT") **vide Circular Number 9/2007** has sought to provide the much awaited clarity relating to application of these new provisions.

A summary and analysis of the key clarifications is being enclosed below:

### Clarification provided

- 1 A foreign company is NOT required to pay FBT if shares are allotted or transferred to employees of its Indian subsidiary. The liability to pay FBT on such shares vests upon the Indian subsidiary by virtue of the employment of the Indian employees with the subsidiary company.
- 2 Where an employee was based in India for only 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. A similar calculation would be done for employees deputed or transferred to India in the year in which the shares were allotted or transferred.
- 3 An employer cannot claim a credit in India for taxes paid by the employees in other countries. However, in the event an employer recovers the tax from the employees, effectively the employee would have paid the tax and hence the latter can claim a tax credit in a foreign country for taxes paid by the employer in India.
- 4 A foreign company listed outside India will have to appoint a category 1 Merchant banker registered with the Securities and exchange Board of India ("SEBI") for valuation of its shares. The merchant banker can however use the listed price as one of the basis of valuation and recommend the best value. Further, an independent valuation carried on by any foreign merchant banker/other experts recognized in a foreign country will not suffice.
- 5 FBT is not payable on stock options granted to non-executive directors or non-employees.
- 6 It is binding on the assessing officer to accept the valuation by the merchant banker, unless it is perverse.
- 7 Amount recovered as FBT is not taxed in the hands of the employers.
- 8 The valuation rule 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 "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"

### Analysis

This clarification provides a breather to foreign companies from the administrative hassles of payment of FBT in India, however, the Government has not taken into account the fact that the allotment or transfer of shares is also by the foreign company, and not by the Indian subsidiary, and hence there lies no merit in imposing FBT on the Indian entity. Further, the situation appears more problematic in situations where the Indian entity does not intend recovering the FBT from its employees, but also does not have enough funds available to pay the FBT.

This clarification is in line with the OECD report on Employee Stock Options, however it does not take into account the fact that in case of an employee on deputation, even if shares are transferred to the employee in the year of transfer, the calculation should be with respect to the length of stay in India during the grant period, and nothing should be attributable in the event that employee has not spent any portion of the grant period in India, thus has not earned the stock option from services rendered in India.

The Government of India while providing this clarification, has recognized the fact that an employee could be doubly taxed in the event he has to pay tax in a foreign country, and an employer recovers FBT from the employee. However, it has failed to recognize the fact that claiming a credit in a foreign country would be a subject matter of the laws of the foreign country, and a credit may not be available considering that the tax would actually have been paid by the employer.

The Government while clarifying that the listed price can be used as one of the basis for valuation, has increased the administrative costs for foreign companies by imposing a condition of appointment of a merchant banker in India. In such a situation, it would have been more apt to use the listed price as also used for Indian companies listed in India.

This clarification is a welcome move, especially in light of the fact that many companies do issue stock options to consultants, and non-executive directors.

This is a welcome clarification, which will go towards reducing tax litigation.

This is also a welcome clarification, which will provide relief to the Indian corporate employers.

While this clarification details the different types of Plans which get covered within the purview of FBT, it does not however clarify FBT implications in case of reverse vesting of stock options.

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### How Cross Border M&A Will Shape

While some of these much awaited clarifications may not have lived up to the expectations of the Indian corporate community, they are still a welcome move which will reduce the currently existing ambiguity on the applicability of FBT on ESOPs.

- Rajesh Pathania & Parul Jain

Source: *Circular No. 9/2007, Dated 20-12-2007*

*Hotline dated October 24, 2007 "Finally...rules for valuations of securities and shares for payment of FBT announced"*

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