

HR Law Hotline

March 02, 2007

EMPLOYEE STOCK OPTIONS: TILL TAX DO US PART

In an entirely unexpected move, the Finance Minister of India ("**FM**"), in the Finance Bill, 2007 presented to the Parliament on February 28, 2007, proposed to bring within the Fringe Benefits Tax ("**FBT**") net the benefit received by employees upon exercise of options under employee stock option schemes formulated by the employer company.

The FM has proposed to delete the provision in the Indian Income-tax Act, 1961 ("**ITA**"), which exempts the value of benefit to the employee at the time of exercise of options under an employee stock option plan which is in accordance with the guidelines issued by the Indian Ministry of Finance (Department of Revenue) in 2001. It is proposed to delete this provision with effect from April 1, 2007. Since this benefit is now proposed to be covered under FBT, it would be excluded from the purview of "perquisites". Accordingly, from April 1, 2007, while no employee would be subject to tax on stock options as such benefit is no longer a perquisite, all employers would be subject to FBT. It is to be noted that FBT is not a deductible expense or a tax creditable against the corporate income tax of the employer. Thus, it is an additional cost burden.

The Finance Bill, 2007 provides that the FBT value would be calculated based on the difference between the fair market value of the shares on the date of exercise and the exercise price paid by the employee. The entire difference would be treated as taxable value of the fringe benefit and thus subject to FBT payable by the employer. However, the actual effective rate of FBT is unclear since the rules for valuation have yet to be announced by the Central Board of Direct Taxes ("**CBDT**"). The FM has stated in a television interview that these rules would determine the rate of FBT.

It is unclear whether the exercise of stock options granted by a foreign parent company to the employees of Indian subsidiary would attract FBT and if it does, which company would be liable to pay the same. It is expected that the Finance Bill, 2007, in its final form, or the CBDT, would clarify this position.

IMPLICATIONS:

With this unprecedented move, there will be a substantial increase in the cost of granting stock options to employees. It is unlikely that companies, especially start-ups, will be able to bear the additional burden of the FBT and it remains to be seen whether they would pass the tax on to their employees at the time of exercise of options. In the event the FBT is passed on, the employees may end up paying tax on the notional gain at the time of exercise, and thus be out of pocket to the extent of the amount of FBT. Such tax would be in addition to the tax payable on capital gains at the time of sale of shares. Till such time as the rules are notified, there would be substantial uncertainty. Employers will soon need to start thinking of other innovative compensation structures to reward, attract and retain talent!

- **Daksha Baxi & Vikram Shroff**

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