

Tax Hotline

June 15, 2007

BREATHING ROOM – BUT FOR LONG? DEADLINE FOR PAYMENT OF ADVANCE FBT, EXTENDED

Employee stock options (“**ESOP**”s) and other kinds of securities, which have, in the past been utilised to incentivise and retain employees, were recently brought within the scope of the fringe benefit tax (“**FBT**”) net pursuant to an amendment introduced by the Finance Act, 2007.

Until recently, the exercise of stock options by an Indian employee was a tax-triggering event in the hands of the employee in India . However, if the ESOP plan was drawn up in accordance with the guidelines issued by the Ministry of Finance for this purpose, the employee could defer tax until the time the shares were sold.

Pursuant to the amendment brought about by the Finance Act, 2007, no tax is payable by the employee at the time of allotment of ESOPs. However, it is the employer who is now required to pay FBT at the rate of 30%¹ whenever there is a direct or indirect allotment or transfer, of any specified security, including ESOPs, shares etc from the employer to the employee. Further, although FBT is calculated by taking into consideration the fair market value of the specified security on the date of vesting, the levy does not get attracted until the employee actually exercises the stock option.

If FBT liability is attracted, the employer becomes liable to pay tax on a presumptive basis, in four quarterly installments spread over the financial year. On each payment date the employer is required to estimate the FBT obligation for the following quarter, and work towards fulfillment of 15%, 45%, 75% and 100% of the FBT obligation. However, the presumptive nature of the FBT levy could prove problematic. As the exercise of options is uncertain and often depends on the prevailing market price of the specified security, it may be difficult for the employers to estimate future exercises. The question then remains that, if the employer's FBT obligation for a particular quarter increases due to a miscalculation or excess exercise of options due to favourable market conditions, whether the employer will be required to pay interest on short payment of FBT in the previous quarter?

There are a number of issues such as this, which have been raised in relation to the FBT on ESOPs. For example, there is a lack of clarity on the manner in which FBT will apply to foreign companies. While India Inc. was hoping that the Government would do away with the entire FBT regime, which was introduced a couple of years ago, the Government has instead added to the corporate community's woes by shifting the tax burden on ESOPs from the employees to the employer. The amendment introducing the levy has therefore, been met with much dismay and confusion.

At the time of introduction of FBT on ESOPs, the Central Board of Direct Taxes had promised to come out with guidelines providing the method for determination of the fair market value of the specified security. Pending these guidelines, employers are at a loss as to how to determine their FBT liability, and may not have been able to fulfill their FBT obligations by June 15th, which is the first date of payment of advance FBT since the introduction of the levy. The Finance Ministry has, in recognition of this difficulty faced by most employers, brought in some breathing room by extending the deadline for payment of the first installment of FBT on ESOPs, by three months. The Finance Ministry has realised that, “in the absence of a method for determination of fair market value, it will not be possible for an employer to determine the value of the first installment of FBT in respect of allotment shares to its employees.”

While the valuation guidelines for determination of the fair market value of specified securities may provide some clarification with regard to valuation of ESOPs, it is hoped that the Government will also come out with a clarificatory circular on other aspects concerning application of the levy to ESOPs. The extension meanwhile, provides some level of succor to the troubled employers of India Inc.

- **Shreya Rao & Parul Jain**

[1] Excludes applicable surcharge and education cess

Source:

- “Govt defers FBT payment on Esops to Sept 15”, Business Standard, June 15, 2007, Section II, Page 1
- “Companies get more time to pay FBT on ESOPs”, Financial Express (Bangalore Edition), June 15, 2007, Page 4

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