

HR Law Hotline

May 27, 2009

INDIAN EMPLOYMENT LAW: FRINGE BENEFIT TAX WITHDRAWAL PROPOSAL TO BOOST EMPLOYEE STOCK OPTIONS

India is right back on the track of its growth trajectory (although it can be argued that it was never derailed). And the government seems to be providing the thrust. Recent news articles suggest that the Indian government is planning to withdraw fringe benefits tax (“**FBT**”) that was levied on several of the benefits extended by companies to the employees. This proposal, if implemented, is likely to significantly boost employee stock option plans and employee share purchase schemes, and their variations, which were significantly affected as a result of the levy of FBT.

BACKGROUND

FBT was introduced in India by the Finance Act, 2005. This regime was borrowed largely from a similar tax regime prevalent in countries like New Zealand and Australia. FBT was extended to employee stock options and similar arrangements pursuant to an amendment introduced by the Finance Act, 2007. As a result, while the employees were not required to pay any tax at the time of grant, vesting or exercise of stock options, the employer was required to pay FBT at the rate of 34% upon exercise of the options. To the extent FBT was attracted, the employer became liable to pay tax on a presumptive basis, in four quarterly installments spread over the financial year. Companies not listed in India offering stock options to their employees were required to appoint the services of merchant bankers in India to provide a valuation report. The tax rate and the procedural requirements made stock options unattractive and unpopular for the employer, although the tax laws allowed the employer to recover the FBT paid from its employees.

To make matters worse for multi-national companies (“**MNCs**”) having subsidiaries in India, the Central Board of Direct Taxes (“**CBDT**”) issued an explanatory circular clarifying that FBT was payable in the event of a foreign parent grant stock options to employees of its India subsidiary, although there was no direct employer-employee relationship (a pre-requisite for FBT), between the foreign parent and the employees of the Indian subsidiary. The CBDT clarification necessitated such MNCs to also appoint merchant bankers in India to value their shares, irrespective of whether the MNCs were listed on a foreign stock exchange.

PRACTICAL ISSUES

Just like is some of the other countries, the introduction of FBT and subsequent extension to stock options, faced severe opposition and criticism in the country. Employers argued that stock options cannot be put under the same basket as other benefits provided by the companies to their employees. FBT on stock options was considered a tax on a notional amount. Further, if the employer recovered FBT from the employees at the time of exercise, this resulted in a situation that the employees had to pay the tax without receiving any cash payout from the employer. From a practical perspective, this also led to a situation that the employer was required to recover the FBT in cases where the employee may have not longer been employed with the company. Not to mention the difficulties in calculation of FBT every time the employee chose to exercise the vested options at varying dates.

PROPOSAL

The proposal to remove FBT is likely to be a boon for various companies in India especially in the current economic scenario and the ongoing global financial crises. It is also likely to throw open more alternatives for structuring compensation packages. With respect to stock options, it will allow companies to incentivise their employees for superior performance by providing long term benefits. This proposal is likely to be of significance especially for start-ups and small & medium enterprises which may not have adequate capital in the short term to attract and retain talent.

The new Government plans to present the Indian Budget in early July which will be anticipated with great interest. Whether the government indeed withdraws the FBT, especially for stock options, and whether it reverts to the earlier taxation regime for stock options, remains to be seen. Hopefully, the proposed withdrawal of FBT does not remain just as an option for the government!

Source of news report: The Economic Times, Mumbai edition, May 27, 2009

- **Vikram Shroff & Parul Jain**

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