

HR & Tax Alert


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India - Amendments to the Finance Bill 2007 recommend further changes to the original proposal on taxation of stock options

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Executive summary

Amendments have been proposed to the provisions of the Finance Bill 2007 ("The Bill") regarding the taxation of stock options. The Bill was originally introduced in the Lower House of the Parliament on 28th February 2007 (for more information please see our Alert of 6th March 2007).

The revised Bill will not acquire legal status until it is approved by both the Houses of Parliament and the President of India. Once approved, the provisions will apply to the Financial Year 2007-08 with effect from 1st April 2007.

Taxation of Stock options – Proposals included in the original bill

Employee Stock Option Plans (ESOPs) no longer taxable on the employee

The original Bill proposed that employees would no longer have been subject to income tax on any benefit realised from participation in an ESOP.

Inclusion of ESOPs under Fringe Benefit Tax ('FBT')

In place of the taxation of ESOPs on the individual, the original Bill had proposed to levy FBT on the employer in respect of any allotment or transfer (directly or indirectly) of any specified securities or discounted shares to its employees (including former employees).

For the purpose of computing FBT, the value of the Fringe Benefit was to be the difference between the fair market value ('FMV') of the securities **on the date of exercise** and the amount recovered from the employee (exercise price).

The method for computing FMV was to be notified by the Central Board of Direct Taxes at a later date.

Capital Gains arising at the time of sale of shares acquired via an ESOPs

As a consequence of ESOPs being brought within the charge to FBT, the value of the specified securities or shares taxed under the FBT would have been considered to be the cost of acquisition for computing capital gains on transfer of such securities or shares

Capital gains are taxed in the hands of employees only.

Taxation of stock options – amended bill

It is now proposed that to determine the value of fringe benefits, the FMV should be ascertained **as of the date on which the option vests** as opposed to the date of exercise as proposed earlier. The liability for payment of FBT will arise on the date of exercise / allotment of the specified securities or shares. The method for computing the FMV as of the specified date will be notified at a later stage.

Furthermore, a new provision has been inserted that allows the employer to recover the FBT paid from the relevant employees.

Other aspects of ESOP taxation remain as per the original Bill.

Impact of the proposed changes

These amendments bring certain advantages to taxpayers compared to the original proposals for three main reasons:

- (i) As the FBT will be calculated on the fair market value on the date of vesting, there is greater certainty on the amount of FBT payable by the employer. Moreover, considering that the fair market value on the vesting date would generally be expected to be lower than the fair market value on exercise date, this may reduce the FBT due. However, in turn this would also mean that the base cost of the shares for capital gains tax purposes in the hands of the employee will also be lower;
- (ii) The law now allows the recovery of the FBT from the employee. Many employers felt that since employees are the sole beneficiaries of ESOPs, there should be some mechanism to pass the FBT burden to them and the proposed provision would allow this; and
- (iii) As compared to the date of exercise, the vesting date is a more easily determinable event in most cases. Hence employers can make a more accurate forecast of FBT cost and also be able to pay advance FBT more accurately.

Some of the issues that need to be addressed are:

- (i) The mode and manner of calculation of “fair market value” is yet to be notified and should be announced soon;
- (ii) While recovery of FBT from employees has been enabled, the accounting and corporate tax treatment of such recovery in the hands of the employer is still to be worked out, especially as FBT is a “below the line” item and not deductible for corporate tax purposes;
- (iii) In a cross-border situation, whether FBT will be payable in cases where the options vest while the individual was outside India but are then exercised when they are in India has yet to be confirmed. Similarly, the FBT implications where options have vested while the individual was employed in India but are being exercised when he is employed outside India are yet to be addressed.
- (iv) It also remains to be resolved whether the enabling provisions allow recovery of FBT from employees where the ESOP or similar equity schemes are subject to regulatory jurisdiction of countries outside India. There may be some kind of supplementary agreement required from Indian employees to enable such recoveries.

These and many other questions are bound to surface as employers start preparing to put the amended proposals into practice.

Next steps

Employers with ESOPs in India should ensure that they are aware of these proposals and their impact on Indian mobility programs as well as Indian employment costs.

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