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## **TAXATION OF ESOPs – PROBLEM PERSISTS**

### ***1. INTRODUCTION***

ESOP is not only an efficient tool to attract and retain the talented employees but also enables the companies to share their prospective wealth with their committed employees. The rationale behind employee stock options is that the employees should have a stake in the company so that they not only share the prosperity of the company but also bear some risk. When the employees become shareholders of the company they have a feeling of ownership and belongingness towards the company which acts as a strong motivational force leading to accelerated growth of the company. Almost all the fortune 500 companies provide stock option schemes to their employees. More than 1,000 employees of Microsoft Corporation have become millionaires through stock options. Infosys Technologies Ltd. virtually pioneered the concept of ESOP in India around a decade back, as a result of which many of its employees have turned millionaires. Several other software, service sector as well as manufacturing companies have also introduced ESOPs. Thus ESOPs became the buzz word in the corporate sector before their popularity was badly marred by a tax known as “Fringe Benefit Tax”.

Fringe Benefit Tax (FBT) was introduced by the Finance Act, 2005, and was intended to be levied as a tax on the employer in relation to fringe benefits collectively enjoyed by employees, in cases where it was not possible to identify the individual benefit given to each employee. The Finance Act, 2007 brought Employees Stock Option Plans (ESOPs) within the ambit of Fringe Benefit Tax (FBT) by inserting a new clause (d) in section 115WB(1). The said clause specifically provided that any specified security or sweat equity shares allotted or transferred, directly or indirectly by the employer free of cost or at concessional rate to the employees shall be regarded as “fringe benefits”. Thus the shares allotted by companies to their employees pursuant to any ESOP scheme on or after 1<sup>st</sup> April 2007 were subject to payment of FBT by the companies. FBT was regarded as nuisance by the industry since it not only considerably increased the burden of tax but also the burden of compliance. Every year before the Budget, the Industry and the Chambers of Commerce made hue & cry for abolition of FBT. At last during this Budget [Finance (No.2) Bill, 2009] our Hon’ble Finance Minister has accepted the demand of the industry and abolished the FBT.

## ***2. FBT ON ESOPs WAS PRIMA FACIE ILLOGICAL***

Ever since FBT was levied on ESOPs it was severely criticised by the industry as well as the Chambers of Commerce. The rationale for levy of FBT, as already explained above, was that the fringe benefits cannot be attributed to individual employees as these are enjoyed collectively by all the employees. The reason as to why FBT on ESOPs is neither reasonable nor logical is the fact that the aforesaid rationale does not hold good for ESOPs, since in the case of ESOPs the benefit given to each employee is easily identifiable in the form of difference between the market value of shares at the time of allotment of shares and the issue price multiplied by the number of shares issued. Thus the stand taken in the Union Budget 2007 by levying FBT on ESOPs appeared to be at variance with the original intent. Hence the abolition of FBT on all sorts employee benefits including on ESOPs is a very welcome move and a step in right direction.

## ***3. INCIDENCE OF TAX PASSED ON FROM EMPLOYER TO EMPLOYEE***

During the Budget Speech by the Hon'ble Finance Minister it seemed as if there shall not be any tax burden of any sort whatsoever on all kinds of fringe benefits enjoyed by the employees, including ESOPs, but this is not so at least in the case of ESOPs since the incidence of tax is proposed to be shifted from the employers to the employees by substitution of the existing sub-clause (vi) of clause (2) of section 17 of the Income-tax Act, 1961 by a new sub-clause w.e.f. 1<sup>st</sup> April 2010 (Assessment Year 2010-11) which reads as under:-

*“(vi) the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.”*

Thus specified securities and sweat equity shares allotted or transferred, directly or indirectly, by employers to employees will be taxed as perquisite in the hands of the employees once they exercise the stock options.

## ***4. RATE OF TAX***

Fringe Benefits by way of ESOPs were subject to tax @ 30% plus Surcharge (10%), Education Cess (2%) and Higher Education Cess (1%). Thus the effective rate of FBT on ESOPs was 33.99% for all employees irrespective of their gross salary. Section 115WK of the Act permitted the companies to recover the FBT paid from their employees. Almost all the companies had amended their ESOP schemes in order to recover the amount of FBT from their employees. The Finance (No. 2) Bill, 2009 proposes that ESOPs be taxed as perquisites in the hands of the employees as a result of which the tax burden will get slightly reduced since the rate of tax will be based on the gross salary of the concerned employee. In case the gross salary is more than Rs. 5,00,000 the employee shall be taxed @ 30 % plus Education Cess (2%) & Higher Education Cess (1%), which means aggregate tax rate of 30.90% instead of earlier tax rate of 33.99%. Therefore in such a case there shall not be much relief for the employee because saving will only be in the form of 10% surcharge that has been abolished in the present Budget. However, the employees in the 10% and 20% tax brackets shall stand to gain to some extent. Overall there shall not be much loss for the exchequer.

## **5. *PROBLEMATIC ISSUES IN TAXABILITY OF ESOPs***

There were certain issues which created problems for employers as well as employees. Let's examine whether the provisions contained in the Finance (No. 2) Bill, 2009 would help in resolving these problematic issues. These issues have been discussed below :-

### **(a) Tax on ESOPs borne by employees without realising the actual gain**

Section 115WC (ba) of the Income-tax Act, 1961 as it stands today provides for the calculation of fringe benefit tax on the value being the Fair Market Value (FMV) on the date on which ESOPs vest with the employee as reduced by the amount actually paid by or recovered from the employee in respect of such ESOPs. Further, as per the provisions of section 115WK, the employer can recover such FBT from the employee. Thus FBT was payable on the notional gain made by the employee in terms of the difference between the fair market value of shares and the issue price. In case the issue price is more than the FMV no FBT is payable. It is worthwhile to note here that the employee realises the actual gain only at the time of sale of shares in the market. There have been number of cases in the recent past where FBT was paid by the employer company since FMV of shares was more than the issue price but before the employee could sell the shares and realise the gain there was sharp drop in the market price of shares resulting in notional loss for the employee instead of the earlier notional gain. However, the employee cannot get back the refund of FBT paid by his employer company despite the fact that the employer company had already recovered the FBT from him pursuant to Section 115WK.

The aforesaid problem still persists because henceforth the ESOPs will be taxed as perquisite and as such the employer company will deduct tax at source from the employee's salary of the month in which the stock option is exercised. Thus the employee will have to bear the tax burden without realising the actual gain which is not fair. Hence it would be appropriate if the old system applicable from the Assessment Year 2001-02 till the Assessment Year 2007-2008 is restored. In a nut shell under the old provisions, which were in place from the Assessment Year 2001-02 till the Assessment Year 2007-2008, the ESOPs were not treated as taxable perquisite in the hands of employees under section 17(2)(iii) of the Income-tax Act, 1961, provided the concerned ESOP Scheme complied with the SEBI guidelines and was also in accordance with the Guidelines notified vide Notification No. SO 1021E dated 11<sup>th</sup> October 2001. In other words mere grant of stock options or even the exercise of stock options, whereby the equity shares were allotted to employees did not attract Income tax till 31<sup>st</sup> March 2007. They were taxed as capital gains only when the shares were sold.

Thus the taxation of ESOPs under the FBT regime was unfriendly for the employees and it shall continue to be unfriendly under the proposed tax laws also. The only benefit being the reduction of tax for the employees who are in lower tax brackets.

### **(b) Different dates for computation of "Fair Market Value"**

Under the new provisions announced in the Union Budget 2009, the value of the perquisite will be linked to the fair market value of the shares on the date of exercise of stock options as against the fair market value at the time of vesting under the FBT regime. The new provision can lead to a very peculiar situation. Suppose a Company has granted stock options to 100 employees on 1<sup>st</sup> January 2009 with vesting period of two years and exercise period of 1 year, then the vesting period will end on 31<sup>st</sup> December 2010 and the employees will have the right to

exercise ESOPs from 1<sup>st</sup> January 2011 till 31<sup>st</sup> December 2011. If the employees start exercising ESOPs from 1<sup>st</sup> January 2011 onwards and if 10 employees exercise ESOP every month on different dates then company will have to keep track of almost 100 different FMVs for deducting tax at source from salaries of the concerned employees. Whereas under the FBT regime the company has to keep track of only one FMV i.e, as on the vesting date which is 31<sup>st</sup> December 2010 in this case. Thus the proposed system may be cumbersome to implement.

Secondly, under the proposed system in case the stock market is rising, the employees have to shell out more tax when shares are allotted to them since the market value as on the date of exercising the stock options will be more as compared to the market value as on the date of vesting of stock options. However it will not have any material difference since FMV of shares as on exercise date shall be taken as the cost of acquisition for the purpose of computation of capital gains tax at the time of sale of shares.

It is worthwhile to note here that under the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 as well as under the Guidance Note titled, "Guidance Note on Accounting for Employee Share-based Payments" issued by the Institute of Chartered Accountants of India for the purpose of valuation and accounting of ESOPs the fair value is taken as on the date of the grant of stock options.

In view of the above facts it is necessary to bring parity between the SEBI Guidelines and the proposed provisions under the Income-tax Act in order to save the companies from the hassle of computing the FMV twice, firstly at the time of grant of stock options and secondly at the time of exercising the stock options. The calculation of FMV on two different dates complicates the matter without serving any meaningful purpose.

The present CBDT circular specifies that FMV shall be taken as the average of the opening & closing price of the shares as on the date of vesting. It is suggested that the FMV may be taken as the average price of six calendar months preceding the relevant date ("grant date" / "exercise date" as may be thought appropriate) instead of considering the price of only one day, since the six months average price will be a better indicator of the fair market value of the shares.

(c) Payment of Advance Tax substituted by Tax Deduction at Source

The earlier provisions required the assessee companies to estimate the total FBT liability for the financial year and pay the same in advance tax installments in June, September, December and March. There was a stipulation of interest liability in case of any failure or short fall in the payment of such advance tax. In order to calculate the amount of advance tax the companies had to estimate the number of stock options that are likely to be exercised by the employees during the financial year, which was not an easy task. Moreover, in case the vesting date fell after the due date of payment of advance tax then it became very difficult to predict the accurate share price which will be treated as the fair market value in case of listed shares.

In view of the abolition of FBT on ESOPs the accounting professionals will not face the aforesaid problems. Now the fair market value has to be calculated on the date of exercise of stock options and based on that the tax has to be deducted at source from the employee's salary.

## **6. CAPITAL GAINS TAX ON SALE OF ESOP SHARES**

The Finance Bill seeks to amend section 49 of the Income-tax Act, 1961 by substituting the existing sub-section (2AA) with the following sub-section w.e.f. 1st April 2010 :-

*“(2AA) Where the capital gain arises from the transfer of specified security or sweat equity shares referred to in sub-clause (vi) of clause (2) of section 17, the cost of acquisition of such security or shares shall be the fair market value which has been taken into account for the purposes of the said sub-clause.”*

Thus as far as computation of capital gains tax at the time of sale of shares is concerned there has not been any change in policy since earlier also it was taxed as the difference between the sale price and the fair market value computed for FBT purposes. Now also the difference between the FMV computed on exercise date for taxing ESOP as a perquisite and the sale price shall be charged to capital gains tax.

## **7. CONCLUSION**

The levy of FBT on ESOPs was regarded as a retrograde step specially for the companies engaged in the IT, Pharma, Bio-technology and FMCG sectors where the employee attrition rate is high. Due to the levy of FBT, the ESOP schemes had become less attractive for the employees and as per the media reports some of the top notch IT companies even stopped giving ESOPs to their employees. Now also the problem persists because of the taxation of ESOPs as perquisite in the hands of the employees. Therefore it would be appropriate to bring ESOPs completely out of the tax net. In other words tax should levied only as capital gains tax at the time of sale of ESOP shares. It is earnestly hoped that the Hon’ble Finance Minister will make the necessary amendments in the Finance Bill before the same is passed by the Parliament. If this is done the ESOPs will regain their lost shine.

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