

Fringe Benefit Tax on ESOPs

Frequently Asked Questions

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1. Introduction to FBT on ESOPs

1.1 What is Fringe Benefit Tax (FBT)?

Fringe Benefits Tax (FBT) is a tax on benefits that employees receive from their employers as a result of their employment.

1.2 How has taxation of stock options changed after the notification of FBT on stock options?

Immediately prior to the FBT notification, gains from ESOPs were liable only to capital gains tax. This tax treatment could, however, be availed only if the ESOP plan was drawn as per the guidelines issued by the Central Government and filed with the tax authorities within the specified time period. If the Central Government guidelines were not complied with, they were taxed as perquisites at the time of exercise, apart from the levy on capital gains tax.

With the new FBT regulations, esops are now classified as fringe benefits. Tax is liable not only at the time of sale but also at the time of allotment or transfer of shares. Most importantly, now the company is liable to pay FBT on benefit arising from stock options at the time of allotment or transfer of shares, as against the scenario earlier where the tax liability was on the employee alone.

1.3 When does the new tax regulation come into effect?

All shares allotted or transferred on or after 1st April 2007 will be liable to FBT.

1.4 Will options vested prior to 1st April 2007, under a tax compliant scheme be liable to fringe benefit tax?

Yes. Irrespective of whether options were granted under a tax compliant scheme or not, if they are exercised and shares have been allotted on or after 1st April 2007 then FBT will be payable.

1.5 Whether tax is liable if options are exercised prior to 1st April 2007 but the shares are allotted by the company after 1st April 2007?

Yes. Even if the shares were exercised by the employee prior to 1st April 2007, but the shares were allotted by the company after 1st April 2007, tax will be payable.

1.6 What will be the date of allotment of under an Employee Stock Option scheme?

The date of allotment shall be the date on which the underlying asset is allotted or transferred to the employee

1.7 Is the company liable to pay FBT even if options were granted through a Trust?

Yes. The company is liable to pay tax even if the options were granted through a trust.

1.8 Whether a foreign company is liable to pay FBT on shares allotted or transferred to the employees of its Indian subsidiary?

Since the shares are allotted or transferred to the employees of the subsidiary, the liability to pay FBT on such shares allotted vests on the Indian subsidiary and not the foreign company.

1.9 If the employee of the Indian subsidiary of a foreign company is allotted or transferred shares while he is outside India, will FBT be applicable?

An Indian subsidiary of a foreign company would be liable to pay FBT in respect of the value of shares allotted or transferred by the foreign holding company if the employee was based in India at any time during the "Grant Period". The grant period is defined as the period between the date of grant and the date of vest.

1.10 Is a foreign company liable to FBT in respect of shares allotted or transferred to employees deputed to work in India?

A foreign company is liable to FBT on the value of shares allotted or transferred to its employees based in India during the grant period.

1.11 Whether the options granted to non-executive directors or non-employees liable to FBT?

Benefit arising out of ESOPs granted to non-employees will not be liable to FBT. However, it will be taxed in the hands of such non-employees in accordance with the existing law.

2. Calculation of FBT

2.1 Who is liable to pay FBT?

The employer is liable to pay FBT. However the law allows the company to recover the tax from its employee.

2.2 When is the tax liability calculated?

The FBT liability will be determined on the date of vesting. So the liability is frozen on the date of vest but payable only on the date of exercise of options.

2.3 How is the value of the fringe benefit on ESOPs calculated?

Fringe benefit value = Number of options exercised x (Fair market value of share on the date of vest - Exercise price of option)

2.4 What is fair market value of share (FMV) on the date of vest?

For listed companies, the FMV of share = average of the opening and closing price of the share on a recognized stock exchange which records the highest trading volume on the date of vesting.

Example -

Company A listed on NSE and BSE; Exercise price Rs. 100; Options vested on 1st March 2007. The opening and closing price on the exchanges as on 1st March 2007 are as follows:

Stock Exchange	Trading Volume	Opening price	Closing price	Average Price
NSE	17,065	183.25	184.45	183.85
BSE	19,169	183.85	184.92	184.39

FMV = Rs.184.39

Value of Fringe Benefit = (Rs.184.39 - Rs.100) = Rs.84.39

Fringe Benefit Tax = 84.39 * 33.99% = Rs.28.68 per option exercised

If on the date of vesting the shares are not traded on any recognized stock exchange, then the FMV will be closing price of the share on the recognized stock exchange that records highest trading volume of shares closest to the date of vest immediately preceding that date.

For unlisted companies, FMV shall be the value as determined by a Category I Merchant Banker registered with the Securities and Exchange Board of India.

2.5 For unlisted companies, till what date will the certificate from the Merchant Banker be held valid for the purpose of FMV?

Unlisted companies will have to obtain a certificate either on the date of Vest or a date which is not more than 180 days earlier than the date of vest.

Example -

Company A had granted options for Rs. 100 per option with the vesting dates as shown in the table.

The first certificate is taken as on 2nd Feb 2007 for Rs.150, on 8th August 2007 for Rs.175 and on 1st December 2007 Rs. 180. The certificate is valid for a period of 180 days.

Date of Vesting	2 nd Feb 2007	2 nd June 2007	2 nd Oct 2007	2 nd Feb 2008	2 nd June 2008
FMV	150	150	175	175	180
Fringe Benefit Value	50	50	75	75	80
Fringe Benefit Tax	=50 * 33.99% =Rs.17	=50 * 33.99% =Rs.17	75 * 33.99% =Rs.25	75 * 33.99% =Rs.25	=80 * 33.99% =Rs.27

2.6 What is the valuation methodology in case of foreign companies not listed on a recognized stock exchange in India?

The foreign companies not listed on a recognized stock exchange in India would be treated as unlisted and the shares for such companies will have to be valued by a Category I Merchant Banker registered with the Securities and Exchange Board of India.

2.7 What would be the valuation methodology if the foreign company is listed on a globally recognized stock exchange?

The Merchant Banker shall use the listed price as one of the basis for valuation and recommend the best value.

2.8 Is it sufficient compliance if the foreign company is valued by foreign Merchant Bankers / other experts for the purpose of valuing fringe benefit arising on account of allotment or transfer of shares?

No, valuation done by foreign Merchant Bankers / other experts is not sufficient. It is mandatory for the valuer to be a Category I Merchant Banker to be registered with the Securities and Exchange Board of India.

2.9 What is the procedure to be followed by the Merchant Banker to determine the FMV for unlisted companies?

The Merchant Banker should apply alternative methods and recommend the most appropriate or best value.

2.10 In case the shares have been valued by more than one Merchant Banker or by one Merchant Banker on more than one occasion, which value should the company use as FMV?

The value that is closest to the date of vesting of the option should be adopted as FMV.

2.11 What is the significance of specified date with respect to the valuation of shares?

The shares are to be valued as on the specified date even though the valuation is carried out by the Merchant Banker before or after the specified date.

2.12 Is it binding on the Assessing Officer to accept the valuation made by the Merchant Banker?

It is binding on the Assessing Officer to accept the valuation made by the Merchant Banker unless the valuation by such Banker is perverse.

2.13 If the FMV as on the date of vest is lower than the exercise price paid by the employee, will the employer be liable to FBT?

No, FBT would not be payable in such cases.

2.14 In case of exercise of options from multiple dates of vesting, which method would be followed LIFO or FIFO for the calculation of FBT?

In cases of multiple vesting, FIFO method shall be followed for calculating the FBT
For example:

An employee has the options with the following details:

Date of vesting	Number of options	FMV
31 st March 2006	300	8
31 st March 2007	300	9

The employee exercises 500 options. Thus for calculating FBT, 300 shares at FMV Rs.8 will be considered first and then 200 shares at FMV Rs.9 will be considered.

2.15 What is the rate of tax for esops?

FBT on esops is calculated at a rate of 30% (plus surcharge and cess).

2.16 What is the applicability of Rule 40C?

Rule 40C is applicable in all cases where specified security or sweat equity shares are allotted or transferred to an employee under any scheme whether it is an Employee Stock Option Plan or an Employee Share Purchase Plan or Employee Stock Ownership Plan or Employee Appreciation Rights, by whatever name called.

2.17 How is FBT calculated in case the employee is based in India only for a part of the “Grant period”?

In case the employee was based in India only for a part of the grant period (defined as the period starting with the date of grant and ending with the date of vest) then a proportionate amount of FBT would be payable.

Grant Period - 365 days Number of days the employee is in India - 200 days Total FBT - Rs.3000 Amount of FBT payable - $3000 \times 200 / 365$ i.e approximately Rs.1644
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3. Payment of FBT

3.1 What are the tax provisions for payment of FBT by the company?

The company is liable to pay advance tax on fringe benefits in four installments. For this purpose company will estimate the total amount of FBT due for each financial year.

3.2 When is the due date for payment of FBT by the company?

The due dates for payment of advance tax are as follows

Due Date of Installment	Amount payable
On or before 15 th June	Not less than 15% of the total estimated liability
On or before 15 th September	Not less than 45% of the total estimated liability as reduced by amount paid in earlier installment
On or before 15 th December	Not less than 75% of the total estimated liability as reduced by amount paid in earlier installments
On or before 15 th March	100% of the advance as reduced by amount paid in earlier installment

3.3 What is the due date for payment of advance tax on fringe benefits for the current financial year (2007-08)?

For the current financial year, companies have been exempted from payment of the installments due on 15th June & 15th September. Companies will now have to pay at least 75% of the total estimated liability within 15th December 2007 and the entire liability by 15th March 2008.

3.4 How will companies estimate the total FBT liability for the financial year?

Companies need to estimate the number of options that are expected to be exercised till the last quarter that is upto 31st March 2008 and then pay the FBT on the same.

3.5 What is the penalty for late payment or short payment of FBT installments?

Failure on part of the company to pay any of the installments or short payment of the installment would impose a liability of 1% simple interest for each month or part of the month on the shortfall of tax.

3.6 What happens if the estimated amount of FBT paid as advance tax exceeds the actual liability of tax for the financial year?

If the amount of FBT paid by the company (based on estimation) exceeds the actual liability, then such excess tax paid can be set off against any other tax payable by the company under the Income tax act 1961.

3.7 What is the mechanism and timing of recovery of FBT?

The law does not provide for any specific mechanism or timing of recovery of FBT.

4. Accounting & Taxation of FBT on ESOPs

4.1 Is tax paid by the company allowed as a deductible expenditure?

The amount of tax paid as FBT will not be allowed as a deductible expenditure for the purpose of computation of taxable income for the company.

4.2 Does the law allow the company to recover the tax from the employees?

Yes. Though tax is payable by the company, the law allows the company to recover the tax from the employees. If the ESOP scheme does not provide for recovery of tax then the law allows the company to modify the scheme terms to recover the tax from employees.

4.3 What steps should the company take to recover FBT from employees?

Companies should calculate the tax liability on each vest date and communicate the same to the employees. Tax can be recovered at the time of exercise along with the payment of exercise price.

4.4 How will FBT on ESOPs be accounted for in the books of the company?

The accounting entries for FBT paid on esops will be as per the guidance note issued by ICAI for Fringe Benefit Tax.

4.5 How would the recovery of FBT be treated in the hands of the employer?

Since FBT is not an allowable deduction in computation of income of the employer, any recovery of FBT would not be treated as income in his hands.

4.6 On sale of shares, what will be the capital gain tax?

On sale of shares, capital gain tax will be calculated as difference between the sale consideration and the fair market value of the shares on the date of vest.

Example -

An employee is granted 1000 options at a price of Rs. 100. On the date of vest the fair market value is Rs. 150.

Fringe benefit tax = $1000 \times (150 - 100) \times 33.99\% = \text{Rs. } 16,995$

The employee sells the shares for a sale consideration of Rs. 250,000.
 Capital gain = 250,000 - (1000*150) = 100,000

4.7 What will be the cost of acquisition if at the time of vest the amount of FBT payable is nil?

If at the time of vest the fair market value of the share is lower than the exercise price, then amount of FBT payable will be nil. Going strictly by the word of law, the capital gain tax at the time of sale of shares will be calculated taking the fair market value of the share as the cost of acquisition.

However it is advisable to consult a tax advisor for this purpose.

Example -

An employee is granted 1000 options at a price of Rs. 100. On the date of vest the fair market value is Rs. 80.

Fringe benefit tax = $1000 \times (80 - 100) \times 33.99\%$ = Nil

The employee sells the shares for a sale consideration of Rs. 150,000.

Capital gain = 150,000 - (1000*80) = Rs.70,000

4.8 Whether the FBT recovered from the employee would form the cost basis for employee for calculating Capital Gain on subsequent sale of shares?

No. The recovery of FBT from the employee by the employer will not change the cost of acquisition of the shares in the hand of the employee. The explanatory circular no.9/2007 dated 20/12/2007 issued by the CBDT & Section 40(2AB) of the Income Tax Act specifically provide for the same.

4.9 Whether the fringe benefit arising on account of shares allotted or transferred under an ESOP is allowed as a deduction in calculating the taxable income of the employer company?

If the employer purchases the shares from the market and then transfers the same to its employees on exercise, the expenditure so incurred is allowable as a deduction in computing the taxable income of the employer company. However, if there is fresh issue of capital by the company, no deduction is allowable in computing the taxable expenditure since no expenditure has been incurred.

- 4.10 If the benefit on account of shares allotted or transferred under ESOPs is taxed in the hands of the employees in different countries, would the employer still be liable to FBT?**

Employer will be liable to FBT in India irrespective of whether employees have been charged to tax in different countries or not. An employer cannot claim credit in India against its FBT liability for taxes paid by employees in other countries

- 4.11 If the employer pays FBT in respect of an employee based in India and such FBT is recovered from the employee, can such employee claim credit for such FBT in the foreign country?**

FBT is a tax imposed on the employer in respect of fringe benefits provided or deemed to have been provided to the employee. The Finance Act allows the employer to recover the FBT from the employee. In case the FBT is paid by the employer and recovered from the employee, such employee can claim credit, in a foreign country, for the FBT, on account of shares allotted or transferred under ESOPs, paid by the employer in India.

- 4.12 Does the employer have an option to charge the benefit arising on account of shares allotted or transferred under ESOPs to be taxed as either perquisite under section 17 of the I.T.Act or as fringe benefit under the I.T.Act?**

Since the benefit arising on account of shares allotted or transferred under ESOPs is liable to be taxed in the hands of the employer as fringe benefit under Chapter XII-H of the Income Tax Act, it cannot be taxed in the hands of the employee as a perquisite under section 17 of the Act.

5. Miscellaneous Issues

5.1 Will modification of the scheme terms be permitted by SEBI?

SEBI guidelines specifically provide that no modification in the scheme terms is permissible if such scheme terms are detrimental to the interest of the employees. *Clarification from SEBI is needed on this front.*

5.2 Are companies yet required to file the ESOP scheme with the tax authorities?

No. The finance Act 2007 has omitted the proviso to the section 17(2)(iii) which required the filing of the scheme with the tax authorities.

5.3 Are foreign companies issuing ESOPs to Indian employees liable to pay tax?

Yes. Foreign companies listed abroad will be liable to FBT. These companies may be listed abroad but if they are not listed on any recognized stock exchange in India, then for the purpose of FBT valuation, the foreign company will be deemed to be unlisted. So for the purpose of valuation, these companies will need to obtain a fair value certificate from the Merchant Bankers.

5.4 How will the FBT recovered from foreign employees affect their personal taxation?

In such cases recourse will be taken from the Double Tax Avoidance Agreements (DTAA) entered between countries. If the DTAA provides for a credit of any amount of tax paid by the employee, then the FBT can be claimed. However this issue is yet not clear and it is advisable to consult a tax expert.

5.5 What is the effect on the amount of FBT in case of corporate actions?

In case of corporate action post vesting (when the amount of FBT liability is frozen), the amount of FBT to be paid by the company will remain unaffected.

Example -

Company A granted 1000 options on 1st November 2006 at an exercise price of Rs.100; options vested on 1st November 2007, when the FMV for FBT is Rs.150;

Fringe benefit value = $(150-100)*1000 = \text{Rs.}50,000$

Fringe Benefit tax = $50,000 * 33.99\% = \text{Rs.}16,995$

On 1st December 2007 company announced a bonus issue in the ratio 1:1, with the market price on the effective date is Rs.75; 2000 options (post corporate action adjustment) are exercised on 15th December 2007.

FBT payable on exercise of 2000 options = Rs. 16,995

5.6 Whether a charge back of costs by a foreign company to the Indian subsidiary is relevant to determine the obligation of the Indian company to pay FBT?

The Indian subsidiary is liable to fringe benefit tax irrespective of whether or not there is a charge back of cost by the foreign holding company.

