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Impact of Budget 2009 provisions on ESOPs

One of the most expected Budget provisions this year was abolition of FBT and the Finance Minister did not disappoint. FBT was one of the most prominent deterrents whenever ESOPs were discussed by employers in India and overseas.

However with respect to ESOPs, the Finance Minister has given with one hand and taken back (arguably more) by the other. ESOPs gains which earlier attracted FBT (@34%) are now proposed to be taxed as Perquisites (at around 30% maximum) in the hands of the employees. On the face of it, it appears that the tax burden would be lower in the new regime, however the devil is in the detail.

Before one gets into the detail of what the Budget 2009 proposes, it is worth the while to re open the issue of when ESOP gains should be taxed. Both FBT and the Perquisite tax are payable at the time of exercise and if the employee decides to hold onto the shares, the gains are not realized and tax is the net outflow. In reality if the prices fall later, the employee would have paid taxes on gains he did not realize. Moreover under both the scenarios, the tax liability could be so high that employees would be forced to sell a part of their holding just to pay the taxes. This clearly is not the intent of issuing ESOPs. The intention is to motivate the employee to hold on to the shares and work towards growing the value for himself as well as other shareholders. What message is the Government giving to the employees?

It would make more sense if the tax is levied on realized gains rather than forcing employees to realize gains to pay taxes. There cannot be any argument for exempting the entire gains from Tax. More logical way would be to tax the entire gains as Capital Gains whenever the sale proceeds are realized. To make this workable, ESOP gains can be excluded from the Long term capital gains which are tax free in case of listed companies. Just as they have a separate mention and treatment in Section 17(2), they could be taxed as an exception.

Comparison of the FBT regime and the Perquisite tax regime

Details	Proposed	Earlier
	Perquisite tax	FBT
Taxable Value	Difference between Fair market value on <u>date of exercise</u> and exercise price	Difference between Fair market value on <u>date of vest</u> and exercise price
Liability of payment	Taxable in the hands of the employees	Taxable in the hands of the Company, recoverable from the employees
Payable when	At the time of allotment or transfer	At the time of allotment or transfer
Tax rate	30.9% (Highest slab)	33.99%

Even though prima-facie it appears that the amount of tax is lower in the new regime. It may not be so in all the scenarios. For calculating the FBT, market price on Vest date was critical whereas in the new regime, market price on the exercise date will be considered. This also has a bearing on the computation of Capital gains. Before taking a view on what is beneficial to employees, its important to look at the total tax liability.

The following tables consider two market scenarios, rising markets and falling markets:

Rising Markets

Amount in Rs.

		Market Price	New Regime			Old Regime		
			Perquisite (C-A) *(30.9%)	Short Term Capital Gains^ (D-C)*(15%)	Total Tax	FBT (B-A) *(33.99%)	Short Term Capital Gains^ (D-B)*(15%)	Total Tax
July-07	Grant (A)	50						
July-08	Vest (B)	200						
July-09	Exercise (C)	240	59		59	51		51
December-09	Sale (D)	300		9	9		15	15
	Total				68			66
Effective Tax Rate					27%			26%

^ Assumed for a listed company

So in a rising market FBT would be frozen on vest date and when the employees exercised at higher prices, their benefit was high and effective FBT was lower. Whereas the Perquisite tax would be higher in a rising markets because more you delay the exercise higher the Perquisite tax. But this is almost made good by lower Capital gains in the new regime.

Falling Markets

Amount in Rs.

		Market Price	New Regime			Old Regime		
			Perquisite (C-A) *(30.9%)	Short Term Capital Gains^ (D-C)*(15%)	Total Tax	FBT (B-A) *(33.99%)	Short Term Capital Gains^ (D-B)*(15%)	Total Tax
July-07	Grant (A)	50						
July-08	Vest (B)	200						
July-09	Exercise (C)	180	40		40	51		51
December-09	Sale (D)	150		-5	-5		-8	-8
	Total				35			43
Effective Tax Rate					35%			43%

^ Assumed for a listed company

Similarly in falling markets, the FBT would be frozen at a higher price on the vest date and when employees exercise at lower prices, their benefit is lower and effective FBT higher. We have seen this scenario where vests occurred in first half of 2008 before the prices fell steeply.

On the whole employees would be better off under the new regime in falling markets and would even out in rising markets.

As one goes through the fine print, there are a few issues which need clarity. Hopefully they will be cleared before the final bill is passed.

1. Whether the 'date of exercise' is the date of exercise by the employee or the date on which allotment of shares is done?

Till the time this is clarified, it can be safely assumed, that since the tax is payable on the date of allotment or transfer, the date of exercise would be the same date.

Moreover date of exercise by the employee is to be considered then it could be either the date on which he submits his exercise form or the date on which his exercise payment is cleared. These dates could be very subjective and difficult to prove to the Tax authorities. Date of allotment can be proved based on the return of allotment / Board minutes.

There is however another practical difficulty which could crop up if the date of allotment is to be taken as the relevant date for calculating Perquisite value, especially in case of ex employees who have exercised their options after they left the employment. The company will not be in a position to allot the shares unless the employee has paid the exercise price. As such the recovery of Perquisite tax will have to be done after the allotment when the exact liability is known. Post allotment of shares the company would have little control on the ex employees for recovering the Perquisite tax. Whether the company can take a stand that no TDS needs to be deducted in this case since they are no longer employees of the company needs to be clarified.

2. 'Fair Market Value' for listed and unlisted companies need to be defined. Whether Rule 40C which defines the process for calculating Fair value for FBT purposes would be applicable needs to be clarified. In absence of clarity, unlisted companies will have no basis to quantify the Perquisite value.

3. Some companies use Trust route for administering their ESOPs. How will the new provisions work in such cases?

The provision refers to "allotment or transfer of shares". So a Trust route, where there would be transfer of shares is covered under the purview of Perquisite tax. There is also an argument that since there is no "employer-employee" relationship between the Trust and the employee, whether the Trust needs to deduct Perquisite Tax. This argument has been long settled in the decision of Infosys, where it was held that Trust is only a vehicle to administer ESOPs and not a separate business entity, hence the company has a responsibility to deduct the tax at source as if the Trust did not exist.

4. In the case of NRI employees FBT was not applicable because of their stay outside India.

For exercises after April 09 by such employees, the companies will now have to deduct and recover Perquisite tax from them. Similarly in case of Indian employees where FBT was deducted and paid since April 09, companies will have to re work the Perquisite value, calculate the difference with respect to FBT and recover the shortfall / refund excess to the employees.

The Finance Minister has promised to present the Tax code within 45 days. Let us hope that the issue of ESOP taxation is addressed to make compliance more simpler for the employers and rational for the employees. ▲▲

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