

Rules for Valuation of Perquisites (ESOPs)

The Finance Act as passed by the Parliament abolished FBT on ESOPs and put in place Perquisite tax. However, there were certain issues that were pending clarification.

The Central Board of Direct Taxes has issued the Income-tax (Thirteenth Amendment) Rules, 2009 - Substitution of Rule 3 and Insertion of Rule 40F vide Notification No.94/2009/F.No.142/25/2009-S O (TPL) dated December 18, 2009.

The tax liability for the employee remaining the same, the breakup of the tax into perquisite tax and capital gains had changed a little. The amended Rules clarify the price that should be considered for the computation of the perquisite value.

The Company is required to deduct tax from the employees on exercise of options.

Current Status - Perquisite Tax

Quantification of Tax

The tax liability will now be determined on the exercise date. Tax would be levied on the difference between the fair market value (FMV) of the shares on the date of exercise by the employee and the exercise price. The tax would be levied on this value at the individual tax rates (plus cess).

Clarification:

FMV for listed companies

FMV shall be the average of the opening price and closing price of the share on the date of exercise by the employee on a recognised stock exchange where there is highest trading volume.

If there is no trading on any recognized stock exchange, then the FMV shall be the closing price of the share on a recognised stock exchange, where there is highest trading volume, on a date closest to the date of exercising of the option and immediately preceding such date.

FMV for unlisted companies

FMV shall be such value of the share in the company as determined by a merchant banker on the date of exercise of options or any date within a period of 180 days prior to the date of such exercise.

The process of getting a merchant banker certification is the same as was earlier prevalent during the FBT regime.

Incidence of Tax

Tax is payable at the time of exercise of options. All options exercised after 1st April, 2009 are liable to TDS, in which case options vested before 1st April, 2009 but not exercised by then would also be liable to perquisite tax.

The company is liable to deduct TDS on the exercise of options by the employee, even if such options are settled through an ESOP Trust.

Open Issues

Exercise date - Date of submission of form by the employee / Date of clearance of cheque / Date of allotment or transfer

The Rules state that -

“For the purposes of clause (vi) of sub-section (2) of section 17, the fair market value of any specified security or sweat equity share, being an equity share in a company, **on the date on which the option is exercised by the employee**, shall be determined in accordance with the provisions of clause (ii) or clause (iii).”

The Rules do not clearly define the date of exercise, it could be the date the employee submits the exercise form or it could be the date his cheque gets cleared or the date the company allots or transfers shares to the employee. So what is the date of exercise that should be considered for the purposes of computation?

If the date of exercise is the date of allotment or transfer or the date of cheque clearance, the employee would not know the amount of tax that is required to be paid on the date that he makes the payment of exercise price.

Practically, it would be feasible for companies to consider the date the employee submits the exercise form as the date of exercise. The employee would be able to know the amount of tax that he is required to pay the day after he exercises his options.

If the date of exercise is the date the employee exercises his option, it would imply that the taxable value per option would differ every day. Companies may limit submission of exercise forms to a certain date in a week so that exercises could be clubbed.

Adjustment for Perquisite Tax

Due to lack of clarity, some companies continued to deduct tax from the employees based on earlier guidelines, while others deducted tax based on the difference between the closing market price one day prior to the date of exercise and the exercise price. Companies would now need to adjust the excess / shortfall of tax from the salary of the employees. For example, if excess tax has been collected, the TDS on the salary of the employee could be adjusted.

How this amount can be adjusted for employees who have separated from the company remains a challenge for companies.

Also, how the FBT collected in this year for the options exercised prior to July 2009 but after April 1, 2009 would be adjusted is still not clear. FBT and TDS being two separate taxes, they cannot be offset against each other.

Clarification is still required whether the FBT on ESOPs could be adjusted against other FBT payable by the company or against TDS.

Action Points for Companies

1. Determine the dates of exercise for individual employees

Date of exercise would be the date the employee submits his form for exercising his options.

This would entail getting dates of exercise of all employees who have exercised their options after April 1, 2009.

2. FMV computation for listed companies

Determine the FMV for each employee based on their date of exercise of options.

3. FMV - Unlisted companies

Obtain a category I merchant banker certification for the value of shares as on the date of exercise or up to a period 180 days prior to that date.

This means that unlisted companies with multiple grants vesting on multiple dates in a year would at a maximum need two certificates per year to compute perquisite tax for the employees.

4. Compute Perquisite Tax

Depending on the individual tax slabs and the FMV as determined, the perquisite tax should be computed.

5. Adjustment for tax deducted earlier

On the basis of the perquisite tax computed, the company would be required to adjust the excess or shortfall of the tax deducted earlier ▲