

Regulation on FBT on ESOPs

The Finance Act as passed by the Parliament has put to rest all (or most of) the uncertainty about the FBT on ESOPs.

While the Tax liability has been confirmed, the Finance Minister has tried to reduce the impact, made the implementation simpler and given a specific authority to the employer to pass on the impact to the employees.

- The impact is lower than was thought of based on the Budget speech, because the liability will now be frozen for once on the vesting date. Appreciation in price after the vesting date is now outside the purview of the FBT. Typically the exercise period is around 3 years after vesting which usually is 1 year. So a fair share of appreciation would be outside the purview of FBT.
- Implementation is simpler because the employer can now quantify the liability on the vesting date and also communicate it to the employees (in case it has to be passed through) well in advance so that they also know the impact. This is much better than keeping everyone in the dark (if the impact is linked to the price on the date of exercise - as proposed in the Budget speech).
- Specific authority to the employer to recover the FBT from employees clarifies doubts about the recoverability of FBT and the authority as per the Scheme document.

Current Status

1. Quantification of Tax

The FBT liability will now be crystalised on the Vesting date. FBT (for both listed and unlisted companies) would be levied on the difference between the fair market value (FMV) of the shares on the date of vesting and the exercise price. The tax would be levied on this value at the rate of 30% (plus surcharge and cess) as mentioned in section 115WA.

2. Incidence of Tax

FBT is payable at the time of allotment or transfer of shares, directly or indirectly (through an ESOP trust). All options exercised after 1st April, 2007 are liable to FBT, in which case options already vested before 1st April, 2007 but not exercised would also be liable to tax.

3. FBT Liability

The company is liable to pay FBT on allotment or transfer of shares. However, the company can recover the tax from the employees. If the existing ESOP scheme does not permit recovery of tax from employees, the company can vary the scheme terms to allow such recovery.

4. FBT Impact for employees

The employee will bear the tax (FBT) burden passed on by the company on exercise of options. At the time of sale of shares, the employee will be liable to capital gains (Long

term or Short term, depending on the tenure of holding) on the difference between the fair market value of the shares on the date of vest and the sale consideration.

5. Effective date

All options exercised on or after 1st April 2007 will be liable to FBT.

Example -

1000 options granted on 1st April, 2006 vesting 100% at the end of 1 year from the date of grant at an exercise price of Rs.100 per option, exercisable within 3 months from the date of vesting.

On 1st April 2007(vesting date), the FMV of the company share is Rs.500. The employee exercised all vested options on 1st May, 2007. The company allotted the shares on 10th May, 2007.

The employee sold the shares on 1st June 2008 at a price of Rs.1,000.

FBT value of ESOPs = (Rs.500 - Rs.100) x 1000 options = Rs.400,000

FBT liability on 10th May, 2007 = Rs.400,000 x 34% = Rs.136,000

Capital Gains on sale of shares = (Rs.1,000 - Rs.500) x 1000 options = Rs.500,000

Tax liability = Nil (in case of Listed company) ; 20% in case of unlisted company

Issues not yet clear

There are a few critical issues which still remain unanswered. Hopefully these should be cleared once the Rules are published.

1. The rate at which the value of FBT would be calculated. As things stand maximum rate of 33.99% seems applicable. This however needs confirmation.
2. The guidelines for determining the Fair market value (FMV) for listed and unlisted companies are to be issued by the Board and are awaited.
3. Any variation made in the scheme terms to recover tax from the employees could be construed as detrimental to the interest of the option grantees, which is specifically not permissible as per the Security Exchange Board of India (Employee Stock Option Schemes & Employee Stock Purchase Schemes) guidelines, 1999. It needs to be seen whether the Tax guidance will prevail over the SEBI guidelines. Clarification from SEBI on this front is needed to make the issue clear.
4. Whether the FBT amount will be considered as “cost of acquisition” in the hands of the employee while calculating the Capital Gains tax liability?
5. Whether the FBT recovered from the employees will be squared off against the FBT paid by the employer or treated as Income?

Action items for Employers

While the Rules are published which will give complete clarity on the ambiguous issues, it would be prudent for the employers to be ready with the impact based on the worst case scenario. Here are some tips.

1. Calculate the impact of FBT on all vested options for each vest separately.
2. Unlisted companies may vary the terms of the scheme to allow them to recover the FBT from the employees. Listed companies may want to wait till SEBI clarifications come through.
3. Employers should decide the mode of recovery of FBT from the employees (either in cash (increased Exercise price) or deduction from salary, or same day sale through designated brokers).
4. At the time of exercise, the employee should specify from which vest the options are exercised. This will enable the employer to calculate the FBT impact.