

Recent ITAT Order on TDS Administration in connection with Exercise of ESOPs – Timing of Chargeability, Recovery / Deduction and Deposit of TDS

1. Background

- 1.1 Out of many stages of employee stock options (“ESOPs”/ “Options”), exercise of Options results in allotment or transfer of underlying shares to the eligible employee and is the first taxable event in the hands of such employee. This is so irrespective of whether the ESOP implementing company (“Company”) is listed or unlisted in India. This tax is popularly known as ESOP perquisite tax and is administered by the Company by way of tax deduction at source (“TDS”) from the pay-roll or is recovered separately in connection with exercise of Options.
- 1.2 From a principle perspective, the aforesaid aspects are presumably not unknown to all concerned, particularly the tax administrators of a Company. However, from practical tax administration point of view, there could be differences in practice by Companies. In the process of exercise, there are few dates relating to necessary action items which often confuses as to determination of date of TDS and subsequently, impacts the date of deposit with the Government.
- 1.3 Recently, Hon’ble Bench of Income Tax Appellate Tribunal (“ITAT”), Hyderabad in the case of Bharat Financial Inclusion Limited vide Order dated 3rd August 2018 upheld that the TDS liability of a Company arises only when underlying shares are allotted post satisfaction of all conditions of exercise (including the payment of ESOP perquisite tax if required under the relevant ESOP Plan) by the concerned employee while negating the tax department’s view that TDS liability arises when an employee submits the exercise application or simply, when he exercises.
- 1.4 By way of this Newsletter, we wish to share our understanding on relevant law and practice on the administration of ESOP perquisite tax read with the principles upheld by the Hon'ble ITAT in the afore-referred case. This may help validate the process of ESOP perquisite tax administration existing in some Companies; yet, for other Companies who have adopted other course being not in consonance with the principles, it may help them in review of their process.

2. Our analysis and views

- 2.1 In connection with exercise of Options, certain action items are initiated and completed by the employee and the Company, both. Some of the action items required to be initiated and completed by an employee necessarily include applying in a prescribed format of exercise, payment of exercise price and payment of perquisite tax or authorizing to deduct from payroll.

- 2.2 Whereas, action items from Company side used to be to check and vouch for completeness of the exercise application, realization of exercise price, realization of perquisite tax or realizability of perquisite tax through payroll, obtaining of approval for allotment of shares, and issue of shares. In case of ESOP trust (“Trust”) route of implementation, Trust shall perform all these action items except allotment of shares which instead transfer the underlying shares.
- 2.3 The date on which an exercise application is submitted by the employee to the Company is called the “Date of Exercise”. Explanation to Section 17(2)(vi) of the Income Tax Act, 1961 (“IT Act”) makes a reference to fair market value of underlying share as on Date of Exercise for the purpose of determination of perquisite value.
- 2.4 the same Section 17(2)(vi) creates the chargeability by referring to the perquisite value of underlying shares allotted or transferred (to the extent given free or at concession from fair market value as on Date of Exercise) to be taxable as part of salary income. Here, the chargeability is with reference to the “Date of Allotment or Transfer”. Thus, a bare reading suggests that the Date of Exercise is relevant for determination of perquisite value and tax thereon; whereas, Date of Allotment or Transfer is relevant for TDS administration.
- 2.5 The Hon'ble ITAT in the afore-mentioned case observed that Section 192 of the IT Act, which seeks to govern TDS, is applicable only on payment basis and not on accrual basis. Thus, mere submission of an exercise application which sets the ground for allotment or transfer of shares is not conclusive. Actual allotment or transfer is considered as if the intended benefit is paid by the Company or received by the employee and the Company is obliged to ensure appropriate TDS thereon and its deposit the same with the Government by stipulated date as if Date of Allotment or Transfer is the date of payment of benefit.
- 2.6 It is generally observed that ESOP Plans of most of the Companies require payment of ESOP perquisite tax as on Date of Exercise with a view to avoid any risk of inadequate realization or non-realization of tax amount from the concerned employee. Even though the tax amount is received as on Date of Exercise (or by any date prior to allotment or transfer), the chargeability to tax and the TDS obligation thereon arises with reference to Date of Allotment or Transfer of shares as per principle upheld in the afore-mentioned case. Thus, it appears that a Company is liable to deposit the TDS within 7th day of the month next following the month during which underlying shares are allotted or transferred. For instance:

Particulars	Scenario- 1	Scenario- 2
Date of Exercise	10th August, 2018	
Date of Allotment or Transfer	25th August, 2018	10th September, 2018
Employee has to pay ESOP perquisite tax, Or in alternate Company has to ensure TDS through pay-roll	By 25th August, 2018	By 10th September, 2018
Deposit of TDS with Government	By 7th September, 2018	By 7th October, 2018

- 2.7 However, if TDS is deposited after exercise but before allotment or transfer, any possible cancellation of the allotment or transfer may be perilous for the employee and put him to extra task in claiming tax refund.
- 2.8 Given the ultimate obligation cast on the Company to account for TDS, it is desirable to realize the same well on-time and deposit it within due date with reference to the Date of Allotment or Transfer of shares. This facilitates a risk-free delivery of shares apart from appropriate compliance with tax laws. This is particularly desirable in case of separated employees intending to exercise and where full and final settlement is already done.

www.esopdirect.com



info@esopdirect.com



+ 91 77740 21582
+ 91 77740 21583

ESOP Direct