Is FBT payable on ESOPs involving foreign shares? – Nov 15, 2007

THE Notification No. 264/2007 dated October 23, 2007 issued by the CBDT, specifying the Income-tax (12 th Amendment) Rules, 2007 seems to have brought in a lot of welcome clarity in terms of the methodology to be adopted for the determination of the Fair Market Value of ESOPs issued by Indian Companies, listed or unlisted. However, the question of levy of FBT, in respect of ESOP schemes given by foreign / overseas companies to employees working in their Indian Subsidiaries, seems to have gone unanswered.

Typically, employees of Indian Subsidiaries of Foreign Companies are given ESOPs involving shares of the foreign holding companies, whose shares may or may not be listed in the foreign bourses. In these cases, while there undoubtedly exists an employer-employee relationship between the Indian Subsidiary and its employees, the question of payment of FBT by the Indian Subsidiary in respect of ESOPs not actually issued by it, could throw up a lot of interesting issues. A reading of the newly announced Valuation Rules does lead one to some definite conclusions about this trick question.

Consider these…….

• The Valuation Rules talk of "valuation of specified security or sweat equity share being a share in the company". If we go into Rule 4(f) of the Rules, we find that the term "equity share" is defined to have the meaning assigned to it in section 85 of the Companies Act, 1956 (1 of 1956). Clearly then, the term "equity share" cannot include shares issued by a foreign company.

• The Valuation Rules repeatedly refer to the opening and closing price of the share in any recognized stock exchange. The term "recognized stock exchange", as per Rule 4(d), "shall have the same meaning assigned to it in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956)". Here again, it is clear that shares which are not listed in any Indian stock exchange are not covered by the Valuation Rules.

• A reading of the Explanatory Statement issued in respect of the new Valuation Rules makes it amply clear that foreign shares are not covered. The said Explanatory Statement reads as under:

"The Finance Act, 2007 amended the provisions of the Income-tax Act to provide that employers will be liable to pay fringe benefit tax on the value of ESOPs granted to employees as and when the ESOPs were allotted or transferred to the employees. The value of ESOPs for the purposes of levy of FBT shall be the fair market value of the ESOPs on the date of vesting of the options as reduced by the amount actually paid, or recovered from, the employee".

In the case of ESOPs allotted by a foreign company to employees of its Indian Subsidiary, in terms of this Explanatory Statement, it is rather clear that the words used "amounts actually paid or recovered from, the employee" would not be applicable as the amounts would actually have been received by the foreign company which had issued the ESOPs and NOT by the Indian Company which has employed the employees who have exercised the options.

• Since the Valuation Rules do not cover foreign shares, the question of whether they are listed in a foreign stock exchange or not, are of academic importance. Thus, in terms of the Valuation Rules, there can be no FBT on ESOPs involving foreign shares, whether listed in a foreign stock exchange or not.

• If we are to go by the Finance Minister's speech at the time of presenting the 2007-08 Union Budget, it would seem clear that the FBT was intended to cover y ESOPs issued by Indian Companies only. Here are the words which the FM used in Para 179 of his Budget Speech:

"A number of companies provide fringe benefits to employees through Employees' Stock Option Plan (ESOP). I propose to bring ESOPs under FBT. The value of the fringe benefit will be determined, in accordance with a prescribed method, on the date of exercise of the option".

• Conceptually, FBT is a presumptive tax that is levied on the employer, in respect of fringe benefits provided to the employee. The main charging Section 115WA(1) of the Income Tax Act provides that, "there shall be charged for every assessment year commencing on or after the 1st day of April 2006, additional income-tax (in this Act, referred to as fringe benefit tax) in respect of fringe benefits provided or deemed to have been provided by an employer to his employees during the previous year at the rate of thirty per cent on the value of such fringe benefits". The pre-requisite for the levy of FBT, as per the charging section, is the existence of an 'employer-employee relationship' and pursuant to which, "the employer should have provided or deemed to have provided fringe benefits to the employees". Though the section does not use the words "his employees", the intent is very clear that what is sought to be taxed are only fringe benefits given by the employer to his employees. In the absence of the employer-employee relationship between the foreign company and the employees of the Indian Subsidiary, no FBT would arise in respect of the ESOPs given by the foreign company.

• While interpreting taxing statutes, one would have to go by the rules laid down by the Courts. In a land mark judgment dated September 8, 2006, the Supreme Court, in M/s Sneh Enterprises v. Commissioner of Customs, New Delhi reported 2006-TIOL-114-SC-AD, has laid down the cardinal principle of statutory interpretation as follows :

"While dealing with a taxing provision, the principle of 'Strict Interpretation' should be applied. The Court shall not interpret the statutory provision in such a manner which would create an additional fiscal burden on a person. It is also true that while two interpretations are possible, the Court ordinarily would interpret the provisions in favour of a tax-payer and against the Revenue". This principle has been followed by various High Courts as well, including in Gursahai Saigal v. CIT [1963] 3 SCR 893.

Read with the FM's Budget speech, it seems very clear that the intention of the Legislature is to levy FBT in respect of ESOPs issued by Indian Companies and not foreign companies.

• From a practical point of view, levy of FBT on foreign shares held by employees of the Indian Subsidiary Company could lead to a lot of difficulties at the ground level. In most cases, capital gains are charged to tax in respect of shares / stock of companies in countries where their principal / registered offices are located, a concept which is incorporated in most Double Taxation Treaties. Assuming that an employee of an Indian Subsidiary exercises options issued to him by the Indian Company's foreign holding company at US$ 1 per option / share, at a time when the fair market value of the share is US$ 5. Let's assume that, due to the newly introduced Valuation Rules, the Indian Subsidiary Company is asked to pay FBT in respect of the fringe benefits amounting to US$ 4 per option / share. Let's further assume that the Indian employee sells the shares allotted to him pursuant to his exercising the options, at US$ 10 per share. In a normal scenario involving ESOPs issued by an Indian Company, such an Indian Company would have FBT in respect of the amount of US$ 4 per share (being the difference between the exercise price and the issued price), while the employee would be liable for capital gains tax in respect of the amount of US$ 5 per share (being the difference between the sale price and the exercise price) and this would have been fair, as there is no double taxation in respect of the same gain or profit element.

In the case of foreign shares, the Indian employee would most likely be required to pay tax income tax in respect of the same gains (a part of which would already have been subjected to FBT in India), and in many foreign countries, the benefits arising under ESOPs is taxed at the time of exercise, in the hands of the employee. Moreover, since the tax payers are different (the Indian Subsidiary pays the FBT in India while the employee pays tax in the foreign country), tax credits would also not be available. The situation would clearly leads to utter chaos, in

• However, there could be a small issue in terms of Rule (3), which states that in a case where, on the date of vesting of the option, the share in the company is not listed on a recognized stock exchange, the fair market value shall be such value of the share in the company as determined by a merchant banker on the specified date.

Could the words "the share in the company is not listed on a recognized stock exchange" cover shares issued by a foreign company, in as much as, these shares are not listed in an Indian stock exchange? If my opinion, the answer is a definite NO, as shares issued by a foreign company cannot be considered as 'share" within the meaning of the Valuation Rules in the first place and this being so, the question of whether these foreign shares are listed or not in a recognized stock exchange does not arise and consequently, the reference to a Merchant Banker is not applicable for foreign shares.

• Even if we were to assume, purely for the sake of argument, that the Valuation Rules do cover ESOPs issued by foreign companies, to Indian employees of their Subsidiaries, the fact remains that the Valuation Rules do not contain any formula on how the fair market value is to be computed. The formula involving the opening and closing prices of shares is only applicable for the listed shares issued by the Indian Companies and there is no logic for extending this to foreign shares. Further, in the case of shares issued by an unlisted Company pursuant to an ESOP scheme, how is it possible for an Indian merchant banker to arrive at the fair market value of the foreign share?

This would be a case which would lead us to the discussion involving the charge and its computation. In several cases, the Courts have held that a charge and its method of computation have to be read together and that, if the computation fails, so does the charge. For instance, in CIT v. B.C. Srinivasa Setty, [1981] 128 ITR 294, the Supreme Court reiterated the principle that the charge and its computation were two parts of an integral whole and concluded therefore, that if the computation could not be done, the charge was not intended to apply.

In the case involving levy of FBT on foreign ESOPs, there is no way the tax can be computed and consequently, the charge or levy is bound to fall.

• Lastly, let's bear in mind that the provisions of the Double Taxation Avoidance Agreements would override the provisions of the Income tax Act, whenever or wherever there is a conflict. Given the situation that many DTAAs provide for taxation of the profits arising out of ESOPs / shares / stock in the host countries (i.e. the countries in which the ESOP issuing companies are domiciled), it might be that the Indian Income tax Act is not empowered to tax the same transactions, in India, in whatever form. This line of thought could also be pursued by the opponents to the levy of FBT on foreign shares.

May we then conclude that FBT cannot be levied on Indian Subsidiary Companies, in respect of ESOPs issued by their parent Foreign Companies?