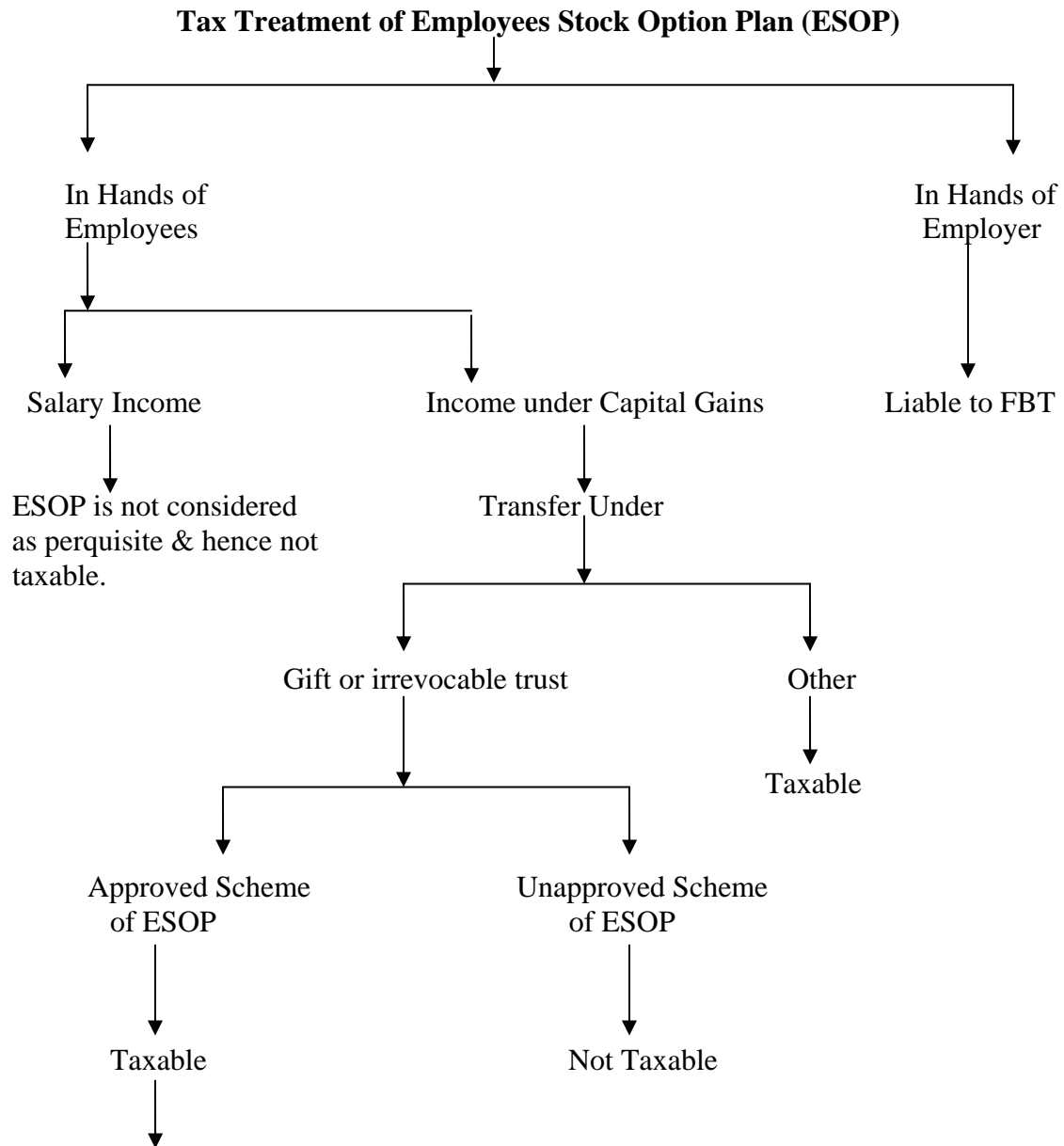


## Tax Treatment of Employees Stock Option Plan (ESOP)

The most debated issue in budget 2007 was taxing of Employees Stock Option Plan (ESOP). Let us evaluate the tax treatment of ESOP from point of view of employee & employer. The following chart shows the summary of tax treatment of ESOP:



*FMV on date of Transfer is deemed to be considered as Full value of consideration received.*

Let us now evaluate in detail tax treatment of ESOP;

**(A) Tax treatment in hands of employee:**

**Salary Income**

ESOP will not be taxed as perquisite in hands of employee irrespective of fact whether it is as per guidelines of central government (ie Approved) or not.

**Capital Gains**

Employees will be subject to capital gains tax when they transfer shares /securities acquired under ESOP following points should be considered while computing capital gains tax liability:

- **Period of Holding:-**

Period of holding shall be reckoned from the date of allotment of shares / securities by employer under scheme to employee.

- **Transfer under Gift or irrevocable trust :-**

As per Sec 47(iii) transfer does not includes transfer of capital asset under gift, or irrevocable trust. However proviso in clause (iii) of sec 47 provides that where an employee transfer by way of gift or irrevocable trust shares received under **Approved** scheme of ESOP such transaction shall be treated as transfer. In such case Fair Market Value on date of such gift, etc will be treated as Full vale of consideration received. However it must be noted that if the scheme is **not approved** (ie not as per guidelines of central government) than such transfer under gift, etc will not be liable to capital gains tax.

- **Transfer otherwise than by gift or irrevocable trust :-**

When an employee transfers shares otherwise than by way of gift, etc ie by sale in open market & so on he will be subject to capital gains tax & in such case sale proceeds received will be considered as full value of consideration. In case of such transfer capital gain will arise whether or not shares /securities are issued by employer under approved scheme or not.

- **Cost of acquisition :-**

For computing capital gain on transfer of shares acquired under Scheme of ESOP by employee Fair Market Value (FMV) on date of **vesting of option** which is taken into account for levy of FBT under section 115WC(1)(ba) shall be taken as cost of acquisition of shares in hands of employee, CBDT vide **Notification No. 264/2007 Dated 23/10/2007** has specified the rule for computing FMV. It must be noted that if any amount is paid by employee as exercise price for acquiring shares under scheme, then such amount is deducted from FMV computed & accordingly on balance amount FBT is levied on employer, but cost of acquisition will be FMV as determined by rule prescribed & not the difference (ie balance amount ) on which FBT is levied on employer.

For instance Mr. B employee of PQR Ltd a listed company is being offered Option to purchase 1000 shares of company at exercise price of Rs.20 per shares on 15/06/2007. On the date of vesting of option FMV as per Rule 40C is Rs.150 per share ,suppose Mr. B exercised the option & subsequently on 10/10/2007 transfers entire shares acquired under scheme than cost for Mr. B will be Rs.1500000(ie 1000 shares \*Rs.150 per share) though company will be liable to FBT on Rs.130000 [ ie 1000 shares \*(150-20)].

• **Rates of tax :-**

Taxability under capital gains will be also subject to period of holding, listing status of company & applicability of Security Transaction Tax (STT). If shares are held for more than 12 months than it is Long term capital asset or else it is Short term Capital asset. If shares are long term ,listed in stock exchange & STT is paid than Long term capital gain arising is exempt from tax under section 10(38). If shares are short term , listed & SST is paid than it will be subject to tax @10%(Plus surcharge & cess).If share are long term & unlisted than it will be taxed @20%. If shares are Short term & unlisted than it will be subject to Slab rate.

**(B) Tax treatment in hands of employer:**

• **Fringe Benefit Tax :-**

Employer will be subject to Fringe Benefit Tax (FBT) under section 115WB(1)(d). 100% Fair Market Value of specified shares or securities on date of *vesting of option* as reduced by amount actually paid by employee will be liable to Fringe Benefit Tax as per section 115WC. The aforesaid fringe benefit will be taxable at the rate of 33.99%

The CBDT vide by *Notification No.264/2007 Dated 23/10/2007* has prescribed the **Rule 40C** for computation of Fair Market Value (FMV) of shares/securities. This rule is summarized as follows:-

<b>Particulars</b>	<b>Fair Market Value</b>
Shares unlisted	As determined by a merchant banker on the specified date(ie date of vesting of option)
Shares Listed	
(a) <i>Trading on the date of vesting of option:</i>	
(1) listed on one recognized stock exchange	1. average of the opening price and closing price of the share on the date of vesting of option on the said stock exchange
(2) listed in more than one recognized stock exchange on the date of vesting of option	2. Average of opening price and closing price of the share on the recognized stock exchange which records the highest volume of trading in the share.

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<p><i>(b) No trading in the share on the date of vesting of option:</i></p> <p>(1) Listed on one recognized stock exchange</p> <p>(2) listed in more than one recognized stock exchange on the date of vesting of option</p>	<p>1. Closing price of the share on recognized stock exchange on a date closest to the date of vesting of the option and immediately preceding such date; or</p> <p>2. Closing price of the share on any recognised stock exchange, which records the highest volume of trading in such share.</p>
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A new section 115WKA is inserted from assessment year 2008-09 which entitles employer to recover amount of fringe benefit tax paid by employer in respect of ESOP issued to employees, from employee by entering into agreement with employee in this regards .This section applies to all ESOP issued on or after 1<sup>st</sup> April 2007.

- **Profits & gains of Business or Profession :-**

It must be noted that employer cannot claim amount of FBT paid (whether or not recovered from employee) as deduction from business income by virtue of section 40(a).

Employer cannot claim amount of ESOP provided to employee as deduction in computing his income under head “Profits & Gains of Business or profession”