POST-BUDGET MEMORANDUM 2019-20

ON

DIRECT TAXES

Personal Tax :

Sl. No.	Section/Subject	Issue	Rationale with factual data	Recommendation
1	Taxation system for ESOPs in the hands of employees	The current Income Tax Law, provides for the inclusion of ESOPs under section 17(2) to be taxed as a "*perquisite*", consequent to the abolition of FBT. The section states that ESOPs issued free of cost or at concessional rates will be taxed on the date of exercise on the difference between the "*fair market value*" on the date of exercise and the amount actually paid by the employee. The "*fair market value*" is to be determined based on stipulated methods which have been separately prescribed by the CBDT.	This suffers from the following drawbacks: (a) It seeks to tax a notional benefit at the time of exercise when the employee exercises his ESOPs by subscribing to the said shares. In fact, he may be funding the said ESOPs by borrowing from external sources at that time of exercise. There is no gain involved. It is possible that the subsequent sale of the shares may even result in a loss to the employee as the stock markets are extremely volatile and share prices fluctuate on a daily basis. Since the perquisite tax is paid earlier, it cannot be set off against the capital loss and the employee suffers a double loss, namely tax outgo and loss on sale of shares.	It is suggested that the taxation of ESOPs as perquisite at the time of allotment / exercise should be avoided. If at all it is taxed, it should be based on the fair market value i.e. the market price prevailing on the date of grant. Any subsequent appreciation should only be taxed at the time of realization / sale as capital gains

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	Taxation system for ESOPs in the hands of employees (*contd. from previous page)*		(b) The question whether the ESOPs are granted at a concessional rate is being determined with reference to the "*fair market value*" on the date of exercise of the options. Technically, this is an incorrect approach. If the ESOPs are issued at the prevailing market price on the date of grant, the issue should be treated as "*non concessional*". This would be in line with the guidelines issued by SEBI. Any subsequent gain accruing to the employee due to favourable market movements by the date of vesting or exercise of option cannot be treated as a "*perquisite*" granted by the employer. (c) Further, if such subsequent gains are a perquisite in the hands of employees, it would stand to reason that the value equivalent of such a perquisite should have been a deductible expenditure in the hands of the company issuing the ESOP. Since the tax law does not contemplate such a deduction, the taxation of the perquisite would result in double taxation.	

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	Taxation system for ESOPs in the hands of employees (*contd. from previous page)*		Also, from the strictly legal angle, there are a number of differences between ordinary shares and ESOP shares. Therefore, they are not comparable. The taxation principles currently existing, result in discrimination. The market value is also strictly not applicable since there are lock-in periods applicable. A detailed note on these aspects is enclosed (**Annexure 1).** Since the actual sale of shares attract capital gains tax, if applicable, it is unnecessary to subject the employee to perquisite tax. In fact, before FBT was imposed on ESOPs, specific provisions existed in the Income Tax Act for exempting the same from perquisites and subjecting it only to capital gains tax. It may be noted that ESOPs have emerged over the years as a critical, motivational and retention tool for companies in a highly competitive market for talent. It is a very effective instrument for encouraging employees to perform and excel and is a win-win proposition for the employers / shareholders on one hand and the employees on the other.	

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2	Surcharge structure on multiple high income slabs (*contd. from previous page*	Surcharge structure was introduced in the UPA regime for high income groups with the specific assurance that it would be a temporary measure. However, it has continued ever since and further, the same was divided into two groups in the earlier budget i.e. 2018. In this year's budget, multiplicity of new slabs in higher income category with different rates have been introduced. This has resulted in four additional slabs for surcharge, which has made the existing tax structure for individuals extremely complicated.	a) Complicated tax structure: In 1997 budget, the tax structure was reduced and made simple and this had an immediate effect on increase in tax collections. However, over the years the tax structure has become more and more complex with multiplicity of income slabs and surcharge slabs on higher income groups. b) High tax rates resulting in risk of tax evasion and impacting overall tax collection: Moreover, tax slabs have resulted in the effective tax rates shooting up which militates against the global trend of tax reduction and simplification. This also encourages tax evasion because of complex and high tax rates. It is necessary to make the tax structure simple with low effective tax rates for ensuring voluntary compliance and better tax collection.	The tax structure should be cleaned up by removal of surcharge and made simple. This will help in attracting fund flows and providing for better domestic capital formation and growth. Also, giving special treatment to foreign funds but taxing of domestic capital at a higher rate should not be done as a measure of fairness and equity. In fact, if foreigners need reasonable taxes, there is no justification to penalize Indian residents. India is no longer a closed economy and therefore, domestic and foreign capital should be equally incentivized.

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	Surcharge structure on multiple high income slabs		c) Foreign funds structured as trusts or AOPs also affected: The high income groups cover not only individuals, but also FPIs which are structured as trusts or AOPs and who are responsible for investment in various countries on behalf of pension funds or other similar bodies holding massive quantum of funds. The surcharges would result in reversing the flow of such funds into the country with consequential impact on capital formation and growth. Already, investment flow has got affected and HNIs are moving out to neighbouring countries like Singapore and Vietnam.	Moreover, already four months of the year have passed and any change in tax rates will affect the past months and create inconvenience in respect of a lot of decisions already taken for transactions effectively closed/completed.

Annexure 1

ESOP shares vis-à-vis Market Shares

They are not comparable

1. ESOP shares are "issued" by the employer and "subscribed" to by the employee, whereas the shares acquired in the market ("market shares") are "transferred" from one shareholder to another. Consequently, while the market shares are goods, the ESOP shares do not become goods until they are allotted in favour of the subscribing employee.
2. It follows that the ESOP shares are not comparable with the shares that are already being traded. Therefore, it is incorrect to quantify any benefit to the employee with reference to the already trading shares or their so-called market value.
3. Even after allotment of the ESOP shares, the employee is prevented by law or the terms of the grant, from selling the shares during a lock-in period, whereas the shares bought in the market can be sold immediately without any restraint. The legal ability of disposition being one of the essential attributes of "property", the ESOP shares, unlike the market shares, are not property in the hands of the employee even after allotment.
4. When on the date of exercise the shares are subject to a lock-in condition, they cannot be considered to be a benefit; and if it is a not a benefit, it ought not to be fictionally treated as benefit and brought under "perquisites". In ***CIT v. Infosys Technologies Ltd.,(2008) 2 SCC 272*, at page 277**, the Supreme Court held as follows:

   "During the said period, the said shares had no realisable value, hence, there was no cash inflow to the employees on account of mere exercise of options. On the date when the options were exercised, it was not possible for the employees to foresee the future market value of the shares. Therefore, in our view, the benefit, if any, which arose on the date when the option stood exercised was only a notional benefit whose value was unascertainable. Therefore, in our view, the Department

had erred in treating Rs.165 crores as perquisite value being the difference in the market value of shares on the date of exercise of option and the total amount paid by the employees consequent upon exercise of the said options."

The Court further, at page 279, held:

"It is important to bear in mind that if the shares allotted to the employee had no realisable sale value on the day when he exercised his option then there was no cash inflow to the employee. It was not possible for the employee to know the future value of the shares allotted to him on the day he exercises his option."

It may be borne in mind that in the Infosys case, the Supreme Court dismissed the Government's appeal not only because the ESOP shares were not enumerated under "perquisites" in S. 17 (2), but also because it does not amount to a benefit.

5. For this reason, also the ESOP shares and the market shares are not comparable, and the latter cannot afford any basis for determining any benefit that may have accrued to the employee on account of the ESOP shares.

Discrimination

6. When a listed company issues IPO or rights shares at a price less than the market value (or bonus shares), the difference between the issue price and the market price is not taxed. If in such a case the difference does not take the character of income, it cannot be income in the case of ESOP shares too.

7. And, if such difference (in the case of IPO/rights/bonus) does take the character of income, then taxing ESOP share alone lacks any intelligible differentia that can validly explain this classification.

8. If a distinction is suggested on the ground that in the case of ESOP shares the benefit takes the character of income from salaries (which is apparent from treating it as "perquisite") which is not so in the case of market shares, it would be incorrect because such income, especially in the nature of salaries, would flow to the employee only when he realizes a gain upon the sale of the shares and not by mere allotment. Therefore, this is not a meaningful distinction.

Valuation

9. The "market value" is taken as on the date of exercise. But the ESOP shares are allotted after a lapse of time, when the market value may not be the same.

10. Even the market value on the date of allotment would not be relevant because the employee would not be able to realize that "value", being prevented from selling the ESOP shares during the lock-in period.

11. Further, the issue of ESOP shares results in expanding the capital base, and a consequent reduction in the intrinsic value of the existing shares. For this reason also, the alleged benefit flowing from ESOP shares cannot be reckoned with reference to the current value of the already existing market shares.