

Global Rewards Update: INDIA

August 2009

THE FINANCE ACT, 2009 RECEIVES FINAL APPROVAL - FRINGE BENEFIT TAX (FBT) ABOLISHED AND INCOME TAXATION ON EQUITY AWARDS REINSTATED

Note: This communication is a further update to the India Global Rewards Update which was released in July 2009.

BACKGROUND AND PRESIDENTIAL ASSENT

On August 19, 2009 Presidential assent was received for the Finance Bill, 2009 ("the Act"), following approval by Parliament earlier this month. The Act is effective retroactively to shares allotted or transferred (i.e. acquired) as of April 1, 2009.

Timing of Taxation of Equity Awards/Sourcing of Awards

Taxation of equity awards will revert to being taxed as "perquisites"; in other words equity awards will now be taxable to employees at the date the shares are acquired by the employees. Employees are liable for Indian income tax on the difference between the fair market value (FMV) and the amount actually paid by the employee for the shares. The Act provides that FMV will be determined in accordance with a prescribed method, though the method has not yet been announced.

- In the case of stock options, the taxable amount will be the spread between the FMV on the date of exercise and the exercise price; as mentioned, the methodology for calculating FMV has yet to be released.
- Similarly, employee stock purchase plans (ESPPs) and restricted stock units (RSUs) would be subject to tax at the time of purchase or vest, respectively.

With respect to globally mobile employees, FBT regulations previously permitted equity awards to be apportioned between India and any other country based on the time spent in India over the applicable sourcing period. While the abolishment of FBT eliminated Indian guidelines with respect to sourcing awards, the prior FBT regulations did align with the Organization for Economic Co-Operation and Development (OECD) guidelines, which permits apportionment based on workdays over the grant to vest period. Thus, while the Act does not explicitly address this issue, the government's past recognition of the need for apportionment may justify continued apportionment of awards based on time spent in India.

Employers should keep in mind that apportionment may be challenged by the tax authorities on a case-by-case basis in each Indian jurisdiction, and within jurisdictions by different assessment officers. Employers would be required to justify apportionment to the authorities if requested.

Employer Withholding and Reporting Requirements

Following Presidential assent to the Finance Bill, employers are required to operate income tax withholding on equity awards, and all amounts withheld in a particular month must be submitted by the 7th day of the following month. However, since the method for calculating FMV has not yet been announced, the exact amount of the benefit on which to withhold remains unclear.

Pending further valuation guidance from the government, employers can choose between two withholding options as outlined below:

1. Operate Withholding on Employee Equity Award Transactions

- Withholding is now mandatory, and must be applied retroactively to shares acquired since April 1, 2009.
- While the valuation methodology has not yet been announced, prior to FBT implementation, in practice, FMV on the date of exercise (for options) and the date of vesting (for RSUs), was determined by reference to a public company's share price if the company was publicly traded on a recognized exchange (e.g. NYSE or NASDAQ).
- Where employers operate withholding on equity awards based on FMV at the date of the tax event based on an FMV as established by a stock exchange, this amount may not match the value on which withholding should be operated when the valuation guidelines are released. The date at which the valuation guidelines will be released has not yet been provided. To the extent that the valuation guidelines establish an FMV value which is lower than using the FMV as established by a stock exchange, any amount that is "over-withheld" can be applied against the employee's remaining withholding obligations in the tax year related to employment income (e.g., salary, perquisites). Adjustments (e.g.,

additional withholding) can also be made from an employee's salary for the balance of the fiscal year (April 1 – March 31) for under-withholding, should the valuation guidance provide for a higher FMV than determined by reference to share price as on a stock exchange.

- It is important to note that it is an administratively difficult process to facilitate a refund of excess withholding, should any excess withholding not be able to be applied to an employee's tax liability for the balance of the fiscal year. It is possible that this might occur in the instance that the gain from the equity compensation is disproportionate to other annual income.
- Employers that begin withholding now can mitigate the impact of retroactive withholding by smoothing out the withholding liability over the remaining tax year.

2. Refrain From Operating Withholding Until the Valuation Methodology is Announced

- Employers should be able to refrain from operating withholding, without incurring interest or penalties, pending further valuation guidance.
- Prior rulings in India support the proposition that without an established computation methodology, withholding cannot be operated.
- Please note that there may be a large balance of withholding which will need to be operated once the valuation guidelines are released. Depending on the timing of the release of the valuation guidelines, there may be a small number of future payrolls in the fiscal year in which the valuation guidelines are released from which to withhold the tax due on the equity compensation.
- Employers who refrain from withholding can minimize the risk of needing to request a refund for excess withholding.

Regardless of which valuation methodology is ultimately adopted by the government, employers are also required to report the taxable value of equity awards, and corresponding tax withholding, on Form 16 (Employer Certificate of Taxable Income). Form 16 must be provided to employees by April 30 of the tax year.

Subsequent Sale or Transfer of Shares

The gain arising from an employee's subsequent sale or transfer of acquired shares will be taxed as capital gains. Where a capital gains liability arises, the employee's basis (i.e. cost of acquisition) in the shares will be equal to the same FMV used to calculate the taxable value of the perquisites.

In the instance where capital gains arise from the transfer of shares which had previously been subject to FBT, the employee's basis remains the value which was taken into account for the

computation of FBT.

Additional Considerations

Qualified/Non-Qualified Plans

Prior to the Indian fiscal year 2007-08, employees were subject to tax in respect of benefits arising from stock options at the time of exercise and restricted stock units at the time of vest. The point of taxation could be deferred to the sale of the shares if an employer operated a qualified plan per the Indian Government Guidelines. While plan qualification offered favorable tax treatment, the Act does not distinguish between qualified and non-qualified plans for purposes of taxation. In other words, under the Finance Act 2009 there is no qualified plan treatment, and taxation cannot be deferred until sale of the shares, even if the plan was qualified prior to the introduction of FBT.

FBT Refunds

With respect to FBT, the Act does not provide any guidance on the treatment of stock option exercises, RSU vests or ESPP purchases which have occurred since April 1, 2009, for which an FBT payment has already been made by the company. Those companies that paid 1st quarter FBT for the current 2008-09 tax year should await further guidance before adjusting any other corporate tax or seeking a refund of the tax paid.

ACTION

- Employers should collect all information related to employee equity transactions since April 1, 2009 and, once additional valuation guidance is provided, calculate the taxable value of these awards.
- Employer should decide now whether to operate withholding on shares acquired since April 1, 2009, or whether they will refrain from operating withholding until definitive valuation guidance is released.
- Affected employees should immediately be notified of the new withholding requirements, and alerted to the potential effect on this year's compensation.

People to Contact

For assistance in this matter or any other issue related to the operation of your global rewards plans, please contact your local Deloitte global rewards consulting services advisor or email us at: globalequity@deloitte.com and a global rewards consultant will contact you.

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