

Representation for withdrawal of FBT on ESOPs

The case for withdrawal of FBT for internet companies

The internet economy in India is a fledgling one as compared to other global economies including China. This industry is poised to rapidly transform the lives of millions of our fellow countrymen by bringing the power of knowledge and information to the masses. At the heart of this economy is a limited core of highly motivated and skilled employees and first generation tech entrepreneurs who are working on cutting edge technologies and striving relentlessly to catapult the Indian online industry to its rightful place on the global internet map. Indeed a number have already attained international fame and recognition.

Many the companies in this space are relatively small start ups working on limited financial resources and lack the size and financial muscle of players in other sectors such as the IT Services sector. However they do need to attract and retain some of the sharpest minds in this country and even from overseas. **Such businesses have been relying heavily on stock options to attract and retain such talent. A number of these businesses, which are not yet generating significant profits are today judged to be very valuable by external markets (perhaps disproportionately so when compared to almost all other industries).**

To take an example, **Rediff.com India Limited**, a member of our association, which has over the past ten years grown to be a leading global internet player has started generating profits only from last year. Net profit for the year ended 31st March 2006 was Rs. 5.50 crores. The stock markets however value this company in excess of Rs. 2000 crores. **Consequently even if 1% of the company's shares were exercised the resultant Fringe Benefit Tax would have not just wiped out the entire profits for last year but would have plunged the company into deep losses.** This would cause great consternation among the investing community upon whom this industry is heavily dependant.

In the interest of growth of the internet industry we would urge you to withdraw this proposed levy on internet companies. Arguments in support of our request include the following:

1. In view of the high value of technology and intellectual property developed by companies in this space the "fair market value" of internet businesses is usually disproportionately high as compared to profits. To tax such companies on the market value of shares rather than on business profits would be putting an undue burden on them.
2. It will be impossible to predict in advance the timing and quantum of FBT and hence the fortunes of a company will swing wildly from period to period merely on account of timing and quantum of exercise. The investing community, on whom this industry is heavily dependant, does not like such surprises.

3. It is the employee and not the company who benefits from such sale and it is therefore logical that the employee should bear the tax on such gain, as is currently the case.
4. Typically employees who leave an organization carry their vested options with them. Levy of FBT on exercise would thus require companies to bear this burden not just for employees but ex-employees as well.

Background

The Finance Bill, 2007 has proposed to levy Fringe Benefits Tax (FBT) @ 33.99% on the benefit granted to employees on exercise of ESOP. For this purpose, clauses 30 and 31 have been inserted which seek to amend section 115WB and 115WC respectively of the Income Tax Act, 1961.

In terms of the proposed amendment, the value of fringe benefit would be the fair market value of the specified security or sweat equity shares on the date of exercise of the option by the employee as reduced by the amount actually paid or recovered from the employee in respect of such security or shares.

The Finance Bill has also proposed to delete the proviso to section 17(2)(iii) which had provided that the benefit granted to an employee under ESOP would be exempt from taxation as perquisites if the ESOP was in accordance with the Central Government guidelines.

Recommendation

It is therefore suggested as under:

1. The proposed amendment should be dropped and the ESOP benefit should only be charged to tax in the hands of the employee OR
2. The proposed amendment should be applied only prospectively to grants made after 1st April 2007
3. In case the benefit is charged to tax as FBT, it should be clarified that the same would not be applicable to ex-employees