



Stock Option Valuation Rules Notified

The Income-tax (Twelfth Amendment) Rules, 2007 (“Valuation Rules”) were notified on October 23, 2007 and shall be effective for the assessment year 2008-2009. These much-awaited rules prescribe the methods that companies must adopt in valuing stock options that have vested with their employees.

These rules are necessary in order for companies to calculate their liability to pay tax on the “fringe benefit” provided by them to their employees by way of stock options. Fringe benefit tax or FBT is a tax introduced in 2006 as an additional income tax. Fringe benefits provided or deemed to have been provided by an employer to employees are taxed at a flat rate of 30% (which along with applicable surcharges results in an effective rate of 33.99%) on the value of such fringe benefits.

Prior to the year 2000, stock options were taxed at two stages *i.e.*, as a *perquisite* on the spread or difference between the exercise price and the fair market value on the date of exercise, and as *capital gains* on the difference between the fair market value on the date of exercise and the price at which the allotted shares were sold. With effect from April 1, 2001, stock options issued in accordance with certain guidelines prescribed by the government (“2001 Guidelines”) were taxed only once *i.e.* at the time of sale, as capital gains. However stock options not in conformity with the 2001 Guidelines (“Non-Qualified Stock Options”) continued to be taxed at both the stages.

By amendments to the Income-tax Act, 1961 in May 2007 (“Amendments”), Non-Qualified Stock Options exercised on or after April 1, 2007 ceased to be treated as perquisites. All stock options are treated as fringe benefits if they are allotted or transferred free of cost or at concessional rate, directly or indirectly by an employer to its employees on or after April 1, 2007.

While employees were taxed under the earlier regime, employers are now taxed on the value of this fringe benefit. Significantly, the Amendments expressly allow employers to vary their stock option agreements and plans/schemes to recover this liability from their employees although this is unlikely to be of relief to employers where option agreements are governed by the laws of jurisdictions other than India. Furthermore, employers are liable to pay fringe benefit tax on the date of exercise although the value of the benefit is pegged to the date of vesting. The employee continues to be liable to pay tax on the sale of shares although capital gains tax shall be levied at this stage on the difference between the sale price and the fair market value on the vesting date.

The Amendments provided for the fringe benefit to be valued at the fair market value of the stock option on the vesting date as reduced by the price paid by the employee. **The determination of fair market value was left to be prescribed by rules to be framed by the tax authorities and these have been released as the Valuation Rules.**

For the purpose of valuing a stock option on the vesting date the Valuation Rules distinguish between companies whose shares are listed on one or more *Indian* stock exchanges and all other companies, whether listed overseas or privately held. Fair market value for shares of the former category of companies is the average of the opening price and closing price of the share on the vesting date or the closest date to it on which trading takes place. The latter category of companies must have the value determined by a merchant banker (registered with the Securities and Exchange Board of India) on the vesting date or on any day within a period 180 days preceding the vesting date.

The 2001 Guidelines were explicit in their applicability to schemes involving foreign holding companies issuing stock options to employees of their Indian subsidiaries. Neither the Valuation Rules nor the Amendments to the income tax statute clarify the applicability of the fringe benefit tax to stock options issued by foreign parent companies. The language of the new taxing provision, however, appears to be wide enough to accommodate the interpretation that it applies to stock options issued by domestic and foreign companies.

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