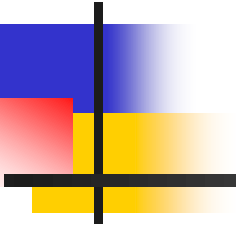


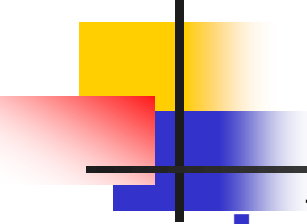
INTERNATIONAL TAXATION COMMITTEE OF THE CHAMBER OF TAX CONSULTANTS



Cross-border ESOPs – FEMA & Taxation issues

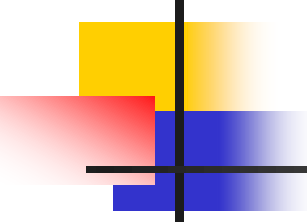
Webinar presented by:
Mr. Paresh P. Shah

P.P. Shah & Associates
Chartered Accountants
Email: ppshahandassociates@gmail.com



Overview of Presentation

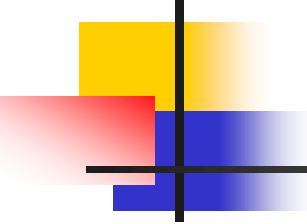
- Introduction to Employee Share based Payments (ESBP)
- Overview of Regulatory Frame-work
- Types of ESBP
- Methods of Implementation
- Legislative history of taxation of ESOPs under Income-Tax Act, 1961
- Taxation of different types of ESOPs under Income-Tax Act, 1961
- Tax deductibility for Employer under Income-Tax Act, 1961
- Special issues in taxation of ESOPs under Income-Tax Act, 1961
- Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad
 - CASES A, B & C
- Overview of issues in Cross-border taxation
- Examples & discussions of issues in Cross-border taxation including OECD Commentary (Examples 1 to 4)
- FEMA implications and regulations relating to ESOP
- SEBI regulations for ESOPs
- Accounting for ESOPs
- ESOPs in USA, UK & Singapore



Employee Share based Payments (ESBP)

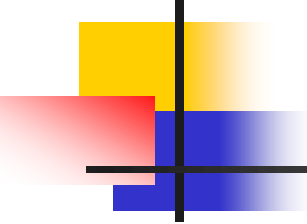
- Introduction

- Employee Share based payments (ESBP) are an effective way of incentivising employees
- Motivates the employees to participate in the growth of the entity, provides an incentive to remain in the company and reap the future benefits.
- Helps the employer to reduce cash outflow, retain the talented workforce, boost the growth rate and align the vision of the employees with that of the company
- It is a useful tool for start-ups or those who are at the growing stage to attract talented human resources. It can also be used for expansion, when an entity is going for acquisition, creating a new division, etc.
- Overall, it leads to improved efficiency, productivity & profits - a win-win situation for all the concerned



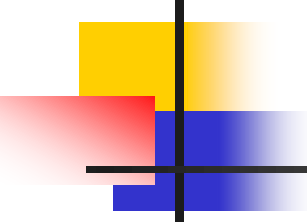
Overview of Regulatory frame-work

- The Companies Act, 2013 read with Rule 12 of Companies (Share Capital and Debentures) Rules, 2014 provides the regulatory framework for granting stock options to employees
- Income-tax Act, 1961 (I.T. Act)
- Foreign Exchange Management Act, 1999 (FEMA)
- Listed companies are further governed by the Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 (SEBI SBEB Regulations) read along with SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
- Accounting and Valuation
 - Registered valuer, Merchant Banker Valuation or in accordance with the accounting policies



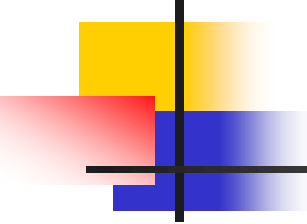
Employee Share based Payments - Types

- **Employee Stock Option Plans (ESOP)**
 - **Employee Share Purchase Scheme (ESPS)**
 - **Stock Appreciation Rights Scheme (SAR) or Phantom Equity Plan (PEP)**
 - **Restricted Stock Units (RSU)**
 - **Sweat Equity Shares**
- The choice of offering a specific type of ESBP depends upon various factors, such as growth strategy of the entity, preference of timing of dilution of equity, degree of dependence on the performance of the entity, regulatory restrictions and tax implications.
 - In many cases these ESBPs are rolled out through employee ownership trusts settled exclusively for the benefit of employees



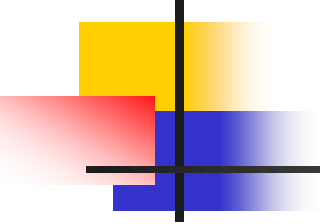
Employee Share based Payments – ESOP

- **Employee Stock Option Plan (ESOP):**
- Company grants options (i.e. right without any obligation) to employees -
 - to acquire a certain number of shares in the company or its holding / subsidiary company
 - generally at a predetermined price (exercise price)
 - within a pre-determined period (exercise period)
- The option to acquire shares can be exercised once the conditions are fulfilled, referred to as 'vesting conditions' which may be continued employment for a defined time or performance based or both.
- Upon vesting, the employee gets an unfettered right to 'exercise' the vested options by payment of the exercise price.
- On exercise, the shares are allotted / transferred to the employees who may sell them subject to lock-in period, if any, specified under the scheme.



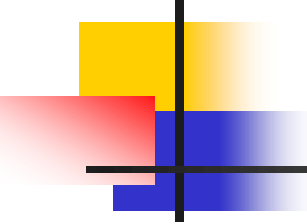
Employee Share based Payments – ESPS

- **Employee Share Purchase Scheme (ESPS):**
 - In an ESPS, employees are granted right by listed entity to acquire shares at a price lower than the prevailing market price.
 - The shares issued under an ESPS are subject to lock-in restrictions during which the employees are required to hold onto the shares and / or continue employment with the Company for a certain number of years
 - The Company can offer shares to employees as part of Public Issue



Employee Share based Payments – SAR / PEP / RSU

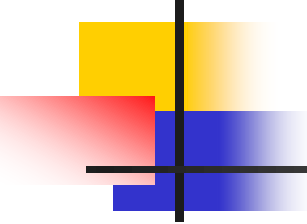
- **Stock Appreciation Rights Scheme (SAR) or Phantom Equity Plan (PEP):**
 - Here, an employee is given notional shares / units at a benchmark price with a right to exit at market price / formula-based price of the SAR or a future formula based price of the phantom unit
 - On exercise, SAR / PEP can be settled either by payment of cash (cash settled SAR / PEP) or by issue of shares (equity settled SAR / PEP)
- **Restricted Stock Units (RSU):**
 - RSUs involve grant of shares (usually without any exercise price) to the employees upon completion of vesting conditions



Employee Share based Payments – Sweat Equity Shares

- **Sweat Equity Shares:**

- Sweat equity shares are defined to mean equity shares issued by a company to employees or directors at a discount or for non-cash consideration for know-how / IP / value addition provided by such employees / directors
- The issue of such sweat equity shares will have to comply with the provisions of the Companies Act, 2013 for the unlisted companies or the SEBI (Issue of Sweat Equity) Regulations, 2002 for the listed companies.



Methods of Implementation

- **Direct Route:**

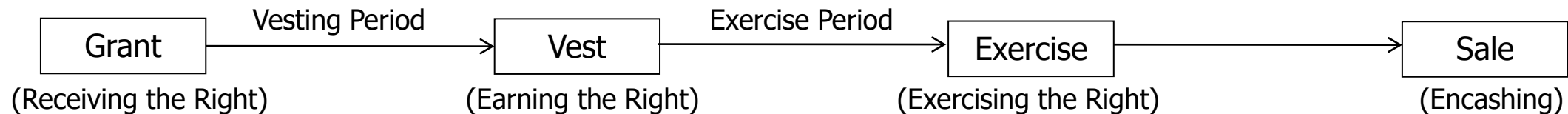
- Here, the employer Company creates an ESOP Scheme with Board and Shareholder approval
- ESOP Scheme is run by the Board / other nominated Committee of the Company
- Cost of implementing is relatively low

- **Through Trust:**

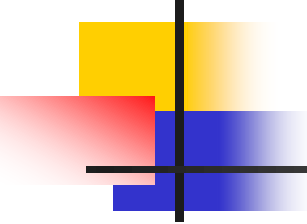
- Trust is created for framing, implementing and running the ESOP Scheme
- ESOP pool is created either by (i) transfer of shares by Founders / specific shareholders to the Trust, (ii) issue of shares by the Company to the Trust, (iii) purchase of listed shares by the Trust
- Cost of creating and maintaining Trust is relatively high

Overview of taxation of ESBP

- Taxation of ESBP vary depending on the type of ESBP
- Plans that result in allotment or transfer of shares to the employees as in ESPS are taxed differently than those that result in payment of cash pursuant to PEP / SAR
- In case of ESOP, it is essential to understand the life cycle or process flow of ESOP –



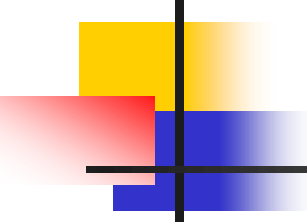
- A country may tax the benefits resulting from an ESOP at one or more of the above events



Taxation of ESOP under I.T. Act

- Legislative history

- Phase I: Prior to 1 April 1999
 - No tax legislative procedures, so covered by general provisions and considered as a taxable perquisite at the time of grant of options [Abbot v. Philbin (44 ITR 144)]
 - Later on, CBDT stated that taxability would be in the year in which option is exercised – four situations were examined [CBDT Circular No. 710 dated 24 July 1995]
- Phase II: Between 1 April 1999 to 31 March 2000
 - Finance Act, 1999 introduced provisions relating to taxation of ESOPs [section 17(2)(iiia)]
 - Taxable as perquisite at the time of exercise of option
- Phase III: Between 1 April 2000 to 31 March 2006
 - Amendment made vide Finance Act 2000 and 2001
 - Proviso was inserted in section 17(2)(iii) and clause (iiia) omitted
 - Scheme to be in accordance with guidelines issued by the Central Government
 - Taxability shifted to the year of sale of shares

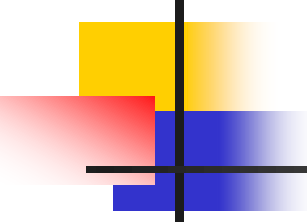


Taxation of ESOP under I.T. Act

- Legislative history (cont'd)

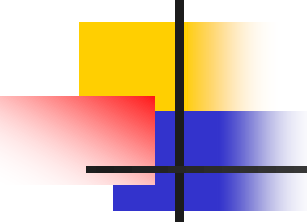
- Phase IV: 1 April 2006 to 31 March 2009
 - FBT provision introduced by Finance Act 2005
 - Taxable as fringe benefit
 - FBT payable by employer
 - Valuation based on vesting date
 - Detailed Circular No. 9 dated 20 December 2007 issued explaining provisions
 - Valuation guidelines prescribed in Rule 40C/ 40D

- Phase V: 1 April 2009 onwards
 - FBT provisions omitted vide Finance Act (No. 2) 2009
 - Taxable as perquisite under section 17(2)(vi)
 - Taxable at the time of allotment and transfer of shares
 - Valuation guidelines prescribed in Rule 3(8)



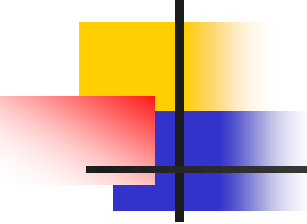
Taxation of ESOP under I.T. Act

- ESOPs are a kind of fringe benefit over and above the employee's salary. Prior to the amendment by Finance Act, 2009, ESOPs were taxable under the ambit of Fringe benefit tax. From 1.4.2010, ESOPs have been made taxable in the hands of the employees as Perquisite under Section 17(2)(vi) of the I.T. Act
- The incidence of tax on the employees, in case of ESOP are at two events: when an employee exercises his option at the exercise price and thereafter, when the shares are sold.
- In the first event, the difference between the exercise price and the fair market value (FMV) of the shares (as determined under Rule 3(8) of the I.T. Rules) is treated as 'Perquisite' in the hands of the employee and the employer is required to deduct tax at source under Section 192 of the I.T. Act. The FMV of the shares allotted to the employee shall be the average of market price, i.e., average of highest and lowest price, on the date when the option is exercised in case the shares are listed. In case of the unlisted shares, the FMV shall be as per the Valuation Certificate obtained from the merchant banker
- In the second event, when the shares are disposed off they will attract Capital Gains Tax. Same can be either long-term or short-term, depending on the holding period.



Taxation of ESPS under I.T. Act

- Unlike ESOP where the options are exercised at a future date usually beyond one year from the date of grant, the allotment or transfer of shares in case of ESPS takes place immediately
- Hence, the underlying perquisite becomes taxable immediately upon such exercise u/s 17(2)(vi). The perquisite will be the difference between the FMV on the exercise date as determined under Rule 3(8) and the price paid for such shares
- In terms of section 17(2)(vi), the FMV to be considered is as on the date on which the 'option' is exercised. In case of ESPS no option is granted but nevertheless the employee gets a right to purchase the shares. This right will be considered as an 'option' for the above purpose
- In case of ESPS, the shares allotted are subject to lock-in period (minimum 1 year prescribed under SEBI SBEB Regulations).



Taxation of SAR / PEP / Sweat Equity under I.T. Act

■ **Cash settled SAR / PEP:**

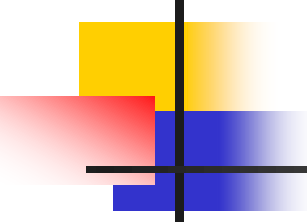
- On exercise of the SAR / PEP, the Company will be obligated to pay cash based on the valuation formula specified for the SAR / PEP. Since this is paid in cash, it is taxable as normal salary.
- The Tribunal (Special Bench) in *Sumit Bhattacharya v. ACIT [2008] 112 ITD 1 (Mum)(SB)* has held that the benefit on account of SAR shall be assessable as salary in the year of redemption.

■ **Equity settled SAR / PEP**

- Where shares are allotted to settle the difference payable to an employee under SARs or PEPs, the perquisite on allotment or transfer of such shares will be taxable in accordance with section 17(2)(vi) based on the FMV of the shares determined as per Rule 3(8)

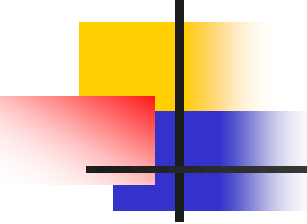
■ **Sweat Equity Shares**

- Section 17(2)(vi) also covers issue of sweat equity shares and hence, the value of perquisite shall be determined with reference to as FMV as per Rule 3(8) & 3(9) less the price paid for such shares, if any.



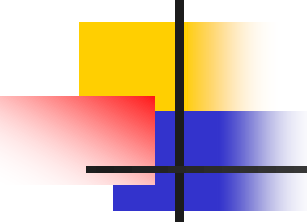
Employer tax implications – Deductibility of ESOP Compensation cost

- The companies allotting ESOPs can claim expense of the compensation cost in calculating profits & gains arising from business u/s 37 of the Income Tax act, 1961
- Various orders passed at ITAT and High Court level have upheld the allowance of expense related to shares issue under ESOP, with the landmark case of M/s Biocon Limited Vs. Dy.CIT (ITAT Bang) being a precedent for many cases including the case of DCIT Vs M/s Kotak Mahindra Bank (ITAT Mum)
- The Delhi High Court upheld the decision of the ITAT in the case of Pr-CIT Vs NDTV (Del HC) regarding treatment of ESOP expenses as ascertained liability and its allowance in P&L account.



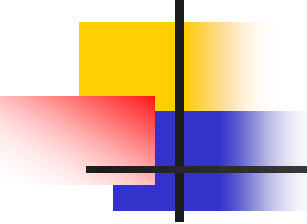
Special issues - Taxation of ESBP implemented through Trust

- In an ESOP Trust, the beneficiaries are usually identified by a class and their individual interest would be indeterminate.
- Such ESOP Trusts set up by the Company will be governed by proviso (iv) to section 164 and accordingly, they will not be taxed at maximum marginal rate but as per the rates applicable to an AOP i.e. as individuals.
- The route of Settlement of shares is less utilised by the Corporates due to tax inefficiency arising from
 - a. Presence of Proviso to Sec 47(3) WEF 1.4.2001 which reads as Provided that this clause shall not apply to transfer under a gift or an irrevocable trust of a capital asset being shares, debentures or warrants allotted by a company directly or indirectly to its employees under any Employees' Stock Option Plan.....
 - b. Proviso 6 to the S.48 WEF 1.4.2001 which reads as Provided also that where shares, debentures or warrants referred to in the proviso to clause (iii) of section 47 are transferred under a gift or an irrevocable trust, the market value on the date of such transfer shall be deemed to be the full value of consideration received or accruing as a result of transfer for the purposes of this section.
- Normally loan from corporates in combination with contribution from employee is preferred



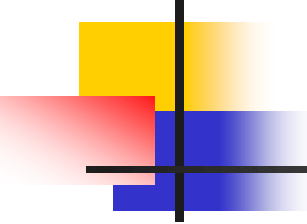
Special issues - Taxation under Section 56(2) of the I. T. Act

- Certain kinds of transactions may attract the deeming provisions of Section 56(2). Examples are –
 - Individual promoter of a company making a grant to employees of the company of which he is a promoter either directly or through a Trust set up for benefit of the employees
 - ❑ As this a gratuitous act and it is one-time in nature, one may argue that it is a capital receipt. In such cases, the application u/s 56(2)(x) may be argued not to apply. However, where the grant to the employees is linked to continued employment or other performance linked conditions, then they may be deemed to be in character of 'Salaries'.
 - Exercise of ESOPs by legal heirs
 - ❑ The exemption for property received under inheritance or Will may not apply in this case as the shares will be received from the Company and not from the deceased employee. It may nevertheless be argued that the right to exercise the vested options devolves upon the legal heirs pursuant to the contract of the Company with the deceased employee and hence, the benefit is flowing on account of inheritance or Will and should be covered by the exemption to section 56(2)(x)



Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad

- **In case an Indian Co. issues ESOPs to employees of its foreign subsidiary who are non-residents, the following alternates by the courts have emerged:**
- **Alternate A:** As ESOPs are issued to employees of the wholly owned foreign subsidiaries ('WOS') and such employees have rendered their services to the WOS abroad and not provided the services in India, would the ESOP be taxable in India as perquisites under the head Salary income, especially in the absence of Employer-Employee relationship between the Indian Co. and the employee of foreign WOS? – **Please see Slides 21 to 28**
- **Alternate B:** In the alternative, as there is no Employer-Employee relationship, would the ESOPs be taxable in the hands of foreign WOS employees as 'Income from other sources' under Section 56 of the I.T. Act? – **Please see Slides 29 to 30**
- **Alternate C:** Whether salary accrues outside India in the hands of the employees of foreign WOS and hence not taxable in India notwithstanding its receipt later in India in the form of ESOP? – **Please see Slide 31**



Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad

- For determining the taxability of salary income of the Employee, the following extracts of relevant sections of the I.T. Act need to be considered
- Section 2(24): "income" includes —
(iii) the value of any perquisite or profit in lieu of salary taxable under clauses (2) and (3) of section 17 ;

Section 5(1) Subject to the provisions of this act, the total Income of any previous year

- Section 5(2): **Subject to the provisions of this Act**, the **total income** of any previous year of a person who is a non-resident includes all income from whatever source derived which—

*(a) **is received or is deemed to be received** in India in such year by or on behalf of such person ; **or***

*(b) **accrues or arises or is deemed to accrue or arise** to him in India during such year.*

Sec 5(2)(b) deals with scope of Total Income in India however **other provisions** of the Act are decisive for computing total Income which in case of Salary are Sec 9(1)(ii) and S 15, 16 and 17 of the Act.



Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

➤ Section 9(1): The following incomes shall be deemed to accrue or arise in India :—

(i) Income derived from.....

(ii) income **which falls under the head "Salaries"**, if it is earned in India.

Explanation.—For the removal of doubts, it is hereby declared that the income of the nature referred to in this clause payable for—

(a) service rendered in India; and

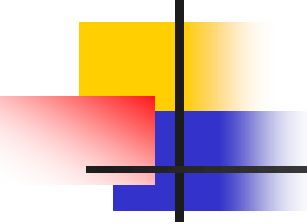
(b) the rest period or leave period which is preceded and succeeded by services rendered in India and forms part of the service contract of employment,

shall be regarded as income earned in India ;

➤ Section 15: The following income shall be **chargeable to income-tax under the head "Salaries"**—

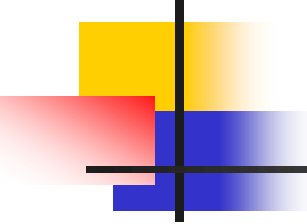
(a) any salary due from an employer or a former employer to an assessee in the previous year, whether paid or not;

(b) any salary paid or allowed to him in the previous year by or on behalf of an employer or a former employer though not due or before it became due to him;



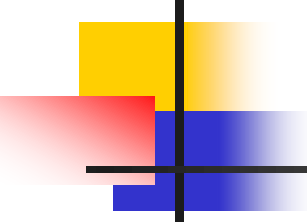
Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

- The word "earned" or the phrase "earned in India " is not defined in the Act. However, as per Explanation to Section 9(1)(ii) w.e.f. 1.4.2000, salary income shall be deemed to be earned in India if the service was rendered in India
- **As the non-resident employee has not rendered the service in India which has given rise to the entitlement and exercise of ESOP, it may reasonably be concluded that the ESOP exercise is not deemed to accrue or arise in India under Section 5(2)(b) r.w. with Section 9(1)(ii) and hence not taxable as salary income in India**



Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

- **However, Section 5(2)(a) brings into the scope all income of a non-resident that is received or deemed to be received in India**
- As the shares on exercise of ESOP would be received in India, it may appear that the income is taxable in India, however this has to be interpreted on a harmonious reading with Section 15 which is the charging section for all income in the nature of salary
- Section 15(a) unequivocally brings salary to tax when it is due whether paid or not
- For determining the incidence of tax on salary income, one may examine four stages – place of rendering of services, accrual of income, the due-date for payment of such income and finally the actual receipt of such income
- On vesting of the ESOPs, the income has fallen due or accrued and would therefore attract the provisions of Section 9(1)(ii) discussed above whereby the income is not deemed to accrue or arise in India as service is not rendered in India
- **Therefore, once it is determined that the said salary income is not taxable in India under Section 15(a) which is the charging section, it cannot again be brought under the ambit of Section 5(2)(a) merely because it is received in India. We will review this in Alternate C based on court's decision**

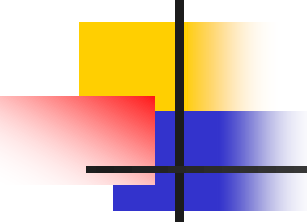


Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

- **However, the Courts in India has also taken a contrary view by the court as under on the basis of the wording of section 15(b):**
 - The provisions of **section 15(b)** of the Act covers within its ambit any salary paid or allowed **by or on behalf of an employer** or a former employer (though not due or before it became due)
 - The ESOPs granted to the employees of the foreign WOS, which although would flow from the Indian parent, would nonetheless be regarded as a benefit paid on behalf of the employer to these employees.

The unwritten presumption in arriving at such a conclusion

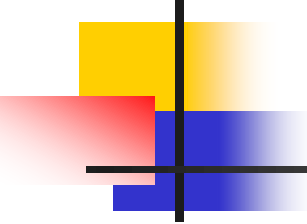
- There may not be any express agreement between the Indian Co. and the WOS for the foreign employees' employment with the WOS, yet those employees would have never been eligible for the ESOPs of the Indian parent Co. had it not been due to their employment with the WOS.



Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

- **Emphasis**

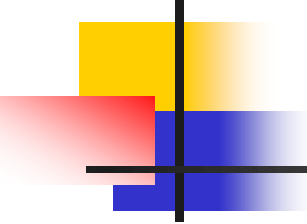
- **Authority for Advance Rulings vide Petition No. 15 of 1998, In re (102 Taxman 74) (AAR)**, relying on the decision of the Hon'ble Supreme Court in case of *State of UP v. Renusagar Power Co. AIR 1988 SC 1737, 1757 & 1758* held that ESOP is a scheme to give encouragement and incentive to the employees of the Indian subsidiary by offering them an option to buy the shares of the foreign parent company of the employer at a pre-determined price and that such a scheme is not possible unless the parent company treats its own business and the business of the subsidiary as one. The intention of the ESOP scheme was to retain the employees' services in India.
- A similar view has been expressed by the Hon'ble Bangalore Tribunal in case of **ACIT Vs. Chittranjan A. Dasannacharya (45 taxmann.com 338) (TBang)**.
- Hon'ble Apex Court in the case of **Justice Deoki Nandan Agarwal v. Union of India [1999] 237 ITR 872** held that what Judges receive, as salary, is reward for their services and it is for this reason that such reward is brought within the scope of salary. The ratio decidendi of the Apex Court's Judgement is that the theory of compensation for services rendered flowing from employer to the employee being sine qua non for taxability under the head 'Income from salaries' is now no longer valid.
- **Therefore, it may be concluded that the ESOPs of the Indian parent Co. received by the employees of the foreign WOS are nothing but a reward of employment (even though there doesn't exist an employer-employee relationship in the conventional sense of the expression) and that income, if any, which may arise on the exercise of the ESOP is liable to be taxed under the head income from salaries as perquisites as the same is in connection with his employment.**



Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

- **Tax implications for foreign employees under DTAA:**

- If the state of residence of the foreign employee follows the residence rule of taxation which is usually the case, the said perquisite earned by the employees from the ESOPs may also be liable to tax in the home country. However, since this leads to double taxation, the foreign employees would be eligible to avail the benefit of the liberal provisions of the Double Tax Avoidance Agreement ("DTAA").
- As example, let us consider that the foreign employees are residents of USA. As per Article 16 of India – USA DTAA, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived there from may be taxed in that other State.
- Thus, as the DTAA gives the taxing rights to the state of residence, the perquisite in nature of ESOP would not be taxable in India (but in the US) as the employment has not been exercised in India subject to the employees furnishing Tax Residency Certificate as stipulated by Section 90(2) of the I. T. Act
- In case the foreign employees were present during anytime of the vesting period of the scheme / plan in India, then the proportion of the taxable perquisites would have to be calculated based on the amount of time spent by such employees during the vesting period in India to the total vesting period.
- However, section 10(6)(vi) of the I. T. Act has provided a short stay exemption (up to 90 days in the previous year) to the non-resident employees from taxation in India under the head "Income from salaries" subject to the fulfillment of certain prescribed conditions. This view is supported by the decisions of the Delhi Tribunal in case of **ACIT Vs. Ellis D Rozario (ITA No. 2918/D/2005)** and **ACIT Vs. Robert Arthur Keltz (35 Taxmann.com 424) (DelhiT)** wherein the Tribunal has held that only such proportion of ESOP perquisite is taxable, which relates to service rendered by such assessee while present in India.



Alternate A - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

- **Conclusion of Alternate A relating to tax implications for foreign employees under DTAA:**

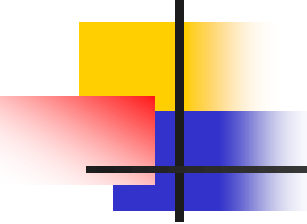
- a) In case of an employee of foreign subsidiary resident in a treaty country:
The above discussions are the most conservative view on the taxability of ESOPs to non-resident employees of foreign subsidiaries as it admits to the taxability of the same in India as salary income and then seeks relief from taxation through the beneficial provisions, if any, of a DTAA between India and the foreign country of residence.
- b) Foreign subsidiary is from a country having no treaty with India:
The ESOPs to employees of such foreign subsidiary would be taxable in India and the Indian Co. would be under an obligation to withhold taxes at the time of exercise of the ESOPs unless a technical view in such a case is accepted that such an income can never be taxed in India on its receipt basis due to operation of Section 15(a) of the I.T. Act, discussed later in Alternate C.



Alternate B - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad

- **Taxability of exercise of ESOP as Income from other sources:**

- A view may be taken that the benefit obtained by the foreign employees of the WOS from the ESOPs of the parent Indian Co. cannot be regarded as a reward of employment as there is no employer - employee relationship and hence not covered under the head 'income from the salaries'. In such a case, the revenue may contend that the same is taxable in India under the head "Income from other sources" u/s 56(1) read with section 56(2)(x) of the Act
- Accordingly, since the ESOPs would be granted to the foreign employees of the WOS at a consideration which would be less than the fair market value of the shares, the resultant difference between the fair market value (as calculated under Rule 11UA) and the consideration paid by the employees, if in excess of rupees fifty thousand, would be liable to tax in the hands of the employees in India under the head "Income from other sources"
- There would be withholding obligations on Indian Co. u/s 195 of the Act since it would be making payments to non-resident
- The employees of the foreign WOS would have to pay the balance tax, if any, and file tax return in India disclosing the income under "Income from other sources" derived from exercise of the options



Alternate B - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

- **Taxability of exercise of ESOP as Income from other sources under DTAA:**

- The taxing right of 'income from other sources' would depend on the DTAA, if any, between India and the foreign country of residence. For example, in case of India – USA DTAA, India has the right to tax 'income from other sources' if such other income has arisen in India
- But has the 'other income' really arisen in India only because the payer i.e. Indian parent Co. is in India whereas the services that has actually given rise to the income are not provided in India?
- Here there is a conflict between Payer and Economic activity which has been the subject matter of numerous jurisprudence (*International Hotel – 228 ITR 534, Wallace Pharma - 278 ITR 97, Dell Intl - 305 ITR 37*) where generally the economic / business activities are treated as a source of income as against the payer of such income
- **Accordingly, a view may be taken that 'income from other sources' has not arisen in India but in USA where the employee has exercised his employment and although the payer is located in India, it cannot be brought to tax in India under the provisions of Article 23(3) of the India-US DTAA**



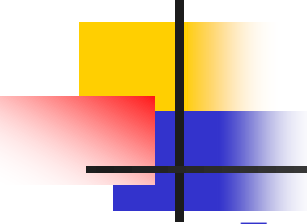
Alternate C - Cross-border tax implications of ESOP issued by Indian Co. to foreign employees of subsidiary abroad

Tax implications of ESOPs in hands of the foreign employees of WOS as Salary accrues outside India:

- Let us consider a view which may be taken on a legal footing, that salary is chargeable to tax on accrual basis irrespective of the fact whether it has been received or not and if salary accrues outside India to a non-resident, then it is clearly not taxable in India and it cannot be brought within the ambit or scheme of taxation in India even though it may subsequently be received in India or it has a source in India.
- In the case of foreign employees of WOS, as they are serving their employment outside India, salary accrues to them outside India. Hence, on exercise of the options, salary in the form of perquisite accrues to them outside India which is not taxable under the I.T. Act and if they subsequently receive the same in the form of sale proceeds of the shares in India or from a source in India, it cannot be taxed in India on receipt basis as that is a mere consequential action of payment after its accrual outside India

Basis of interpretation as above

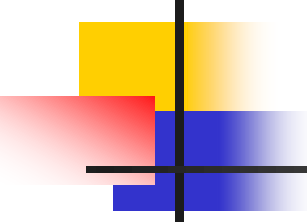
- In the case of ***Ranjit Kumar Bose Vs. ITO [(1986) 18 ITD 230 (Calcutta)]*** it was held that as the assessee was a non-resident in service with a foreign employer, the salary income could not have been brought to tax on accrual basis for the simple reason that it accrued outside India. The provisions of section 5(2)(a) are subject to section 15, which, inter alia, says that salary is chargeable to income-tax on due basis irrespective of the fact whether it has been received or not. So, salary income is not liable to be taxed in India on receipt basis under section 15.
- The Hon'ble Delhi High Court in the case of ***CIT Vs Anant Jain [(2012) 21 taxmann.com 19 (Delhi)]*** dealt with a similar matter where the assessee, now 'not ordinarily resident', received retirement benefit / severance / vacation engagement from erstwhile employer in USA on termination of employment. It was held that as the erstwhile employer was based in USA and services were rendered to the erstwhile employer in USA, the said income did not accrue or arise in India and the said amount cannot be taxed in India when the income was received by him even though the status of the assessee during the year in question was that of 'not ordinary resident'.



Interpretation Under ITA 1961

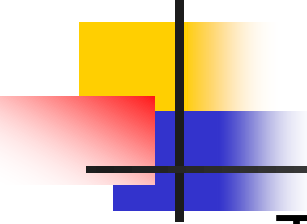
- Sec 5 subject to other provisions of the Act
- Total income of any previous year.....of a person who is resident
- Includes all Income from whatever sources derived ...
 - (a) Is received....or
 - (b) accrues in india or
 - (c)accrues or arises outside India

Explanation 2...Income which has been included on the basis ofshall not again be included on the basis that it is received or deemed to be received by him in India



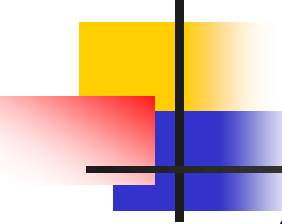
Interpretations under ITA

- Sec 9(1) – Following Income is deemed to accrue/arise in India
- (ii)Income which falls under the head Salaries.....
- Sec 15 The following income shall be chargeable to Income Tax under the head Salaries.....
 - (a)Any salary (referred to in Sec 9(1)(ii) and is due...
 - (b)any salary paid or allowed
 - (c)any arrears of salary paid or allowed.....



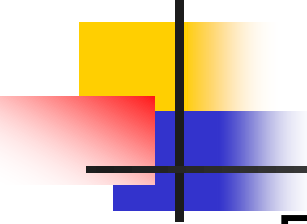
Interpretations under ITA

- The following sequence emerges from the I.T Act
Payer – Source – Accrues/Arise – Deemed to Accrue/Arise – Due – Allowed – Paid – Received– Deemed to be received
- The above sequence has been confirmed in the decision of CIT vs Nippon Yusen Kaisha(1998) 233 ITR 158 (Kol) stating that charging provision will override Sec 5(2) which specifies the scope of total Income
- In Avtar Singh Wadhvan (2001) 247 ITR 260 (Mum) court ruled that payer's location has no relevance in ascertaining the source of income or where the income has accrued



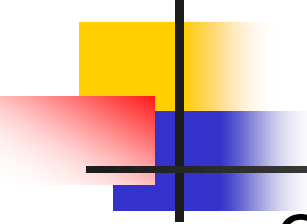
Interpretations under ITA – Court Rulings

- Salary accrues where services are rendered (where the employment is physically exercised) – Utanka Roy vs DIT (2017) 390 ITR 109 (Kol) by following CIT vs Prahlad Vijendra Rao (2011) 198 Taxmann 551 (Kar)
- Location where salary is received is not important - CIT vs L W Rusell (1965) AIR 49 (SC), also refer c.no 13 of 2017
- Texas Instruments Pvt Ltd AAR No 1299 – Even Salary paid in India and in US both were taxable in US only



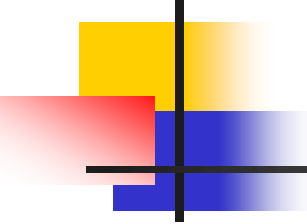
Interpretations under ITA – Inbound Deputation

- ESOP granted prior to the deputation of services to India in such a case ESOP attributable to the services rendered in USA is not chargeable to tax in India – ACIT vs Robert Arthur Kaeltz ITAT (Del)
- Most of the inbound deputation has invoked huge amount of litigation in the area of reimbursement of salary vs fees for technical services including existence of a service PE or DAPE – Centrica India Off shore Pvt Ltd (2014) 365 ITR 336 (Del) following Morgan Stanley's case in 292 ITR 416 (SC)
- Decision in Centrica has been distinguished in many cases based on the peculiar fact in Centrica's case



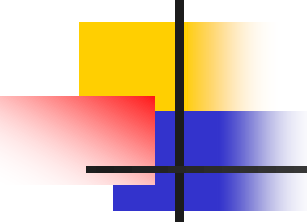
Interpretations under ITA – Inbound Deputation

- Other areas of litigations are Net off tax payment, social security contribution, daily allowance, transportation allowance paid by Indian employer to the deputed employees by the foreign parent. Most of the issues are resolved, However it appears that litigation of the type in Centrika may continue based on the peculiar facts



Overview of issues in Cross-border taxation

- In the present era of globalisation, employees are often deputed or engaged internationally. Further, as the life cycle of an ESOP is spread over many years, it may be possible that employees would have moved to many countries during this period
- Taxation of the employees in such cases can be complicated as each of the countries in which the employee may have worked during the entire life cycle of an ESOP may tax ESOPs in differing manner
- Typically, a country may tax the benefits resulting from an employee stock-option plan at one or more of the following events: (i) when the option is granted; (ii) when the option vests or irrevocably vests; (iii) when the option is exercised or otherwise disposed of; (iv) when there are no longer any restrictions on the sale of the shares acquired under the option; or (v) when the shares acquired under the option are sold
- There can be situations of either double taxation or double non taxation when the State of residence and the State of source do not tax at the same time
- Credit for taxes withheld can also pose some challenges



Overview of issues in Cross-border taxation (cont'd)

- **Thus, cross border income tax issues arise on account of:**
 - Timing mismatch in taxing the employment benefit
 - Distinguishing employment income from capital gains - differentiation in source rules, tax rates and withholding tax liability
 - Difficulty in determining to which services the option relates
 - Employment services provided in more than one country i.e. place of rendition of service between grant - vesting – exercise
 - Compliance Issues
 - Lack of clarity on tax treatment on cancellation/ replacement of options
 - Obligation to deduct TDS
 - In case of ESOPs granted to Indian employees under global ESOP plan, whether obligation to deduct tax is on actual payer (foreign affiliate or parent issuing shares) or employer (Indian Company)
 - Section 204 of the I.T. Act – person responsible for making payment is employer for salary income
 - In case of ESOPs issued under the ESOP trust mechanism, is there an obligation to deduct tax?

Example of issues in Cross-border taxation

Ex. 1 - Resident in different countries & timing mismatch

- **Facts:**

- Employee X, who is a resident of State A, worked seven months in State B. Part of the remuneration that X derived from his employment in State B was stock-options of company Y, a resident of State B
- Under State B law, the employment benefit resulting from stock-options is taxed when the shares are sold and is deemed to correspond to the difference between the sale price of the shares and the strike price (the amount paid by the employee)
- But in State A, the employment benefit resulting from stock-options corresponds to the difference between the value of the shares when the option is exercised and the amount paid by the employee; that benefit is taxed when the option is exercised
- X exercises the option in year 1, when he is taxed in State A as resident
- X sells the shares in year 3, when State B taxes him on the gain as source state

Example of issues in Cross-border taxation

Ex. 1 - Resident in different countries & timing mismatch – cont'd

- The condition in Article 15 of OECD Model Tax Convention for taxation by the State of source is that the income concerned is derived from the exercise of employment in that State, regardless of when that income may be paid, credited etc. (*Ref. Paragraph 2.2 of the OECD Commentary on Article 15*)
- State B can therefore tax the gain in accordance with Article 15. However, State B will levy that tax upon the sale of the shares. Since State A will have already taxed the same benefit two years earlier, how will relief from double taxation be granted?
- Will State A be able to argue that State B has taxed a different event so as to deny relief? Finally, should State A attempt to determine which part of the tax levied by State B corresponds to what it taxes (i.e. the difference between the strike price and the value of the share at the time that the option was exercised)?
- Thus, different country rules for taxing stock-options create risks of double taxation. Same risk arises with respect to any part of an employee's remuneration, including his salary, but the fact is that it is more likely to be a problem in the case of stock-options because **stock-options are often taxed at a time (e.g. when the option is exercised or the shares sold) that is very different from the time when the employment services are rendered.** (*Ref. Paragraph 12 & 12.1 of the OECD Commentary on Article 15*)

Example of issues in Cross-border taxation

Ex. 1 - Resident in different countries & timing mismatch – cont'd

- The above problem of relieving double taxation due to timing mismatch is partly addressed by the fact that the application of the relief of double taxation provisions of the OECD Model Convention is not restricted in time, i.e. relief must be given even if the State of residence taxes at a different time than the State of source
- This, however, may not solve the issue as regards the countries that do not follow Article 23A or 23B of the Model Tax Convention, for instance because they link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. These countries, however, would be expected to seek other ways to relieve the double taxation which might otherwise arise
- *Ref. Paragraph 32.8 of the OECD Commentary on Articles 23A and 23B*

Example of issues in Cross-border taxation

Ex. 1 - Resident in different countries & timing mismatch – cont'd – OECD commentary

- **Paragraph 2.2 of the OECD Commentary on Article 15**

2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee.

- **Paragraph 12 & 12.1 of the OECD Commentary on Article 15**

12. The different country rules for taxing employee stock-options create particular problems which are discussed below. While many of these problems arise with respect to other forms of employee remuneration, particularly those that are based on the value of shares of the employer or a related company, they are particularly acute in the case of stock-options. This is largely due to the fact that stock-options are often taxed at a time (e.g. when the option is exercised or the shares sold) that is different from the time when the employment services that are remunerated through these options are rendered.

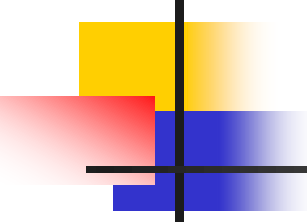
12.1 As noted in paragraph 2.2, the Article allows the State of source to tax the part of the stock-option benefit that constitutes remuneration derived from employment exercised in that State even if the tax is levied at a later time when the employee is no longer employed in that State.

Example of issues in Cross-border taxation

Ex. 1 - Resident in different countries & timing mismatch – cont'd – OECD commentary

- **Paragraph 32.8 of the OECD Commentary on Articles 23A & 23B**

32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23 A or 23 B in their bilateral conventions and link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. These countries, however, would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year.



Example of issues in Cross-border taxation

Ex. 2- Apportion between Salary & Capital Gains

- **Facts:**

- Employee E is resident and working in State A on 1 January 1998
- He is granted an option to purchase shares for a price of 1, conditional on remaining in that employment at least until 1 January 2001
- On 31 December 1999 he moves to work in State B, where he becomes a resident
- He exercises the option on 1 January 2001 when the market value of the shares acquired is 7
- He does not sell any shares until 31 December 2002, when the market value is 9
- **Both State A and State B tax at exercise and State B also taxes when the shares acquired are sold**

Example of issues in Cross-border taxation

Ex. 2- Apportion between Salary & Capital Gains - - cont'd

- The gain that arises between the grant of the option and the date of vesting and exercise, i.e. 6, should be regarded as income from employment covered by Article 15. State A may tax the part of the stock option benefit that was derived from employment carried on there. If each working year is 260 days, then State A may tax 2/3 of this gain, i.e. 4 (this results from the conclusions presented in the section below which deals with the determination of the employment services to which the option relates).
- State B should provide relief for this tax, either by an exemption or credit method
- But once the stock option has been exercised, then the employee is in the same position as any other shareholder. The gain that relates to the period between acquisition and sale of the shares acquired under the option will fall under Article 13 and State B, as the State of residence, will therefore have sole taxing rights on this gain.
- *Ref. Paragraphs 12.2 to 12.5 of the OECD Commentary on Article 15*

Example of issues in Cross-border taxation

Ex. 2- Apportion between Salary & Capital Gains - cont'd – OECD commentary

- **Paragraphs 12.2 to 12.5 of the OECD Commentary on Article 15**

12.2 While the Article applies to the employment benefit derived from a stock-option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the employer or issuer). Once the option is exercised or alienated, however, the employment benefit has been realised and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the employee obtained from his employment, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

Example of issues in Cross-border taxation

Ex. 2- Apportion between Salary & Capital Gains - cont'd – OECD commentary

- **Paragraphs 12.2 to 12.5 of the OECD Commentary on Article 15**

12.3 The fact that the Article does not apply to a benefit derived after the exercise or alienation of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the State of source. Thus, the State of source could tax the relevant income at the time the option is granted, at the time the option is exercised (or alienated), at the time the share is sold or at any other time. The State of source, however, may only tax the benefits attributable to the option itself and not what is attributable to the subsequent holding of shares acquired upon the exercise of that option (except in the circumstances described in the last sentence of the preceding paragraph).

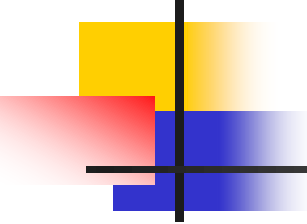
12.4 Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has been exercised, sold or otherwise alienated, it does not matter how such benefit, or any part thereof, is characterised for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the State of source to tax the benefits accruing up to the time when the option has been exercised, sold or otherwise alienated, it will be left to that State to decide how to tax such benefits, e.g. as either employment income or capital gain. If the State of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise since this will be considered to fall under Article 13 of the Convention, it may well decide to tax such increase as employment income rather than as a capital gain under its domestic law.

Example of issues in Cross-border taxation

Ex. 2- Apportion between Salary & Capital Gains - cont'd – OECD commentary

- **Paragraphs 12.2 to 12.5 of the OECD Commentary on Article 15**

12.5 The benefits resulting from a stock-option granted to an employee will not, as a general rule, fall under either Article 21, which does not apply to income covered by other Articles, or Article 18, which only applies to pension and other similar remuneration, even if the option is exercised after termination of the employment or retirement.



Example of issues in Cross-border taxation

Ex. 3 - Services rendered in multiple states

- **Facts:**

- An employee stock-option relates to a period of 3 years of employment (each year has 220 working days)
- During year 1, the employee is a resident of State A (the country of which the employer is a resident) but provides services during 110 days in State B (his presence there exceeds 183 days, which gives that country source taxing rights) and during 20 days in State C (because the employee's presence does not exceed 183 days and the other conditions of paragraph 2 of Article 15 are fulfilled, State C does not have source taxing rights under Article 15 of the A-C treaty)
- During years 2 and 3, he is a resident of State D where he provides all his services
- Where the employment services to which a stock-option relates have been provided in more than one State, an allocation rule is necessary for purposes of the application of Article 15 and Articles 23A and 23B
- A logical allocation method would be to consider that the employment benefit attributable to a stock-option has to be attributed to services performed in a particular country in the proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment from which the stock-option is derived has been exercised.

Example of issues in Cross-border taxation

Ex. 3 - Services rendered in multiple states

- cont'd

- Therefore, 90/660 of the benefit should be allocated to the services rendered in State A, 110/660 to the services rendered in State B, 20/660 to the services rendered in State C and 440/660 to the services rendered in State D
- This allocation applies for purposes of determining to what extent the stock-option benefit is derived from services rendered in each State
- This is necessary for the purpose of determining the extent to which Article 15 gives taxing rights to the State of source as well as for the purpose of determining on what part of the benefit the State of residence must provide relief of double taxation under Article 23
- As explained in the section that deals with multiple residence taxation, this allocation will not be sufficient to avoid the double taxation that can result from timing mismatches in the taxation of stock options by different States of residence
- OECD has also recommended that Contracting States should be free to agree bilaterally to adopt other approaches for the determination of whether and to what extent a particular employee stock-option is derived from employment services rendered in a particular State, keeping in mind that such departures may create difficulties in situations where other States are involved

Example of issues in Cross-border taxation

Ex. 3 – Services rendered in multiple states - cont'd – OECD commentary

- **Paragraphs 12.14 & 12.15 of the OECD Commentary on Article 15**

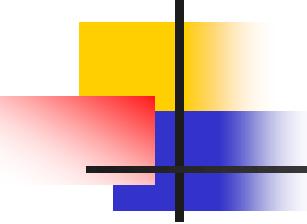
12.14 Where, based on the preceding principles, a stock-option is considered to be derived from employment exercised in more than one State, it will be necessary to determine which part of the stock-option benefit is derived from employment exercised in each State for purposes of the application of the Article and of Articles 23 A and 23 B. In such a case, the employment benefit attributable to the stock option should be considered to be derived from a particular country in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the stock option is derived has been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock-option plan, e.g. those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option.

Example of issues in Cross-border taxation

Ex. 3 – Services rendered in multiple states - cont'd – OECD commentary

- **Paragraphs 12.14 & 12.15 of the OECD Commentary on Article 15**

12.15 It is possible for member countries to depart from the case-by-case application of the above principles (in paragraphs 12.7 to 12.14) by agreeing to a specific approach in a bilateral context. For example, two countries that tax predominantly at exercise of an option may agree, as a general principle, to attribute the income from an option that relates primarily to future services to the services performed by an employee in the two States between date of grant and date of exercise. Thus, in the case of options that do not become exercisable until the employee has performed services for the employer for a specific period of time, two States could agree to an approach that attributes the income from the option to each State based on the number of days worked in each State by the employee for the employer in the period between date of grant and date of exercise. Another example would be for two countries that have similar rules for the tax treatment of employee stock-options to adopt provisions that would give to one of the Contracting States exclusive taxation rights on the employment benefit even if a minor part of the employment services to which the option relates have been rendered in the other State. Of course, member countries should be careful in adopting such approaches because they may result in double taxation or double non-taxation if part of the employment is exercised in a third State that does not apply a similar approach.



Example of issues in Cross-border taxation

Ex. 4 – Relieving double taxation

- **Facts: Let us consider the same Example No. 3 above to understand methods of relieving double taxation**
 - An employee stock-option relates to a period of 3 years of employment (each year has 220 working days)
 - During year 1, the employee is a resident of State A (the country of which the employer is a resident) but provides services during 110 days in State B (his presence there exceeds 183 days, which gives that country source taxing rights) and during 20 days in State C (because the employee's presence does not exceed 183 days and the other conditions of paragraph 2 of Article 15 are fulfilled, State C does not have source taxing rights under Article 15 of the A-C treaty)
 - During years 2 and 3, he is a resident of State D where he provides all his services
- As already discussed, it would seem appropriate to consider that, in that case, 90/660 of the benefit should be allocated to the services rendered in State A, 110/660 to the services rendered in State B, 20/660 to the services rendered in State C and 440/660 to the services rendered in State D.

Example of issues in Cross-border taxation

Ex. 4 – Relieving double taxation

- cont'd

- State A will therefore be entitled, under each of the A-B, A-C and A-D treaties, to tax the whole of the employment benefit from the stock-option provided that it does so while the employee is a resident of State A (which it will do if it taxes at grant)
- In that case, however, it will be obliged to provide relief of double taxation as regards the taxation, by State B, of 110/660 of the benefit and the taxation, by State D, of 440/660 of the benefit (these parts correspond to the services rendered in these States for which Article 15 of the A-B and A-D treaties gives source taxing rights to these States)
- As a State of source, State B will only be entitled to tax 110/660 of the benefit under the A-B and B-D treaties
- Both the A-C and C-D treaties will prevent State C from taxing any part of the benefit
- Finally, under each of the A-D, B-D and C-D treaties, State D will be entitled to tax the whole of the benefit as a State of residence as long as it does so while the taxpayer qualifies as a resident of State D. In that case, State D will be obliged to provide relief of double taxation as regards the taxation, by State A, of 90/660 of the benefit and the taxation, by State B, of 110/660 of the benefit.

Example of issues in Cross-border taxation

Ex. 4 – Relieving double taxation

- cont'd

- However, let us consider a situation where State A taxes the employment benefit at grant while State D taxes it at exercise. In such a case, State A will have taxed the whole benefit in year - 1 while State D will have done the same in year - 3
- Article 15 of the A-D treaty will not restrict either State's right to tax any part of the benefit since the taxpayer is a resident of each State when that State considers the income to be derived and therefore applies the Article, i.e. at the time of grant (year 1) for State A and at the time of exercise (year 3) for State D
- Article 23 of the A-D convention will then require each State to provide relief of double taxation, through the credit or exemption method. Thus State A will be required to provide relief for the tax levied by State D on the part of the benefit that relates to the services rendered in State D in year 2 and 3 (440/660 of the benefit). Conversely, State D will be required to provide relief for the tax levied by State A on the part of the benefit that relates to services rendered in State A in year 1 (90/660 of the benefit)
- The result will be that neither State A nor State D will provide relief for taxes levied in the other Contracting State on the part of the benefit that relates to services provided in State B (110/660 of the benefit) or in State C (20/660 of the benefit)

Example of issues in Cross-border taxation

Ex. 4 – Relieving double taxation

- cont'd

- The example above shows that there are cases where Article 23 would not relieve residence - residence double taxation of the employment benefit arising from an employee stock-option. The mutual agreement procedure could, however, be used to deal with such cases. One possible basis to solve such cases would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State.
- *Ref. Paragraphs 4.1 to 4.3 of the OECD Commentary on Articles 23A & 23B*

Example of issues in Cross-border taxation

Ex. 4 – Relieving double taxation

– cont'd – OECD commentary

- **Paragraph 4.1 to 4.3 of the OECD Commentary on Articles 23A & 23B**

4.1 Article 4, however, only deals with cases of concurrent full liability to tax. The conflict in case a) may therefore not be solved if the same item of income is subject to the full liability to tax of two countries but at different times. The following example illustrates that problem. Assume that a resident of State R1 derives a taxable benefit from an employee stock-option that is granted to that person. State R1 taxes that benefit when the option is granted. The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise. In that case, the person is taxed by each State at a time when he is a resident of that State and Article 4 does not deal with the issue as there is no concurrent residence in the two States.

4.2 The conflict in that situation will be reduced to that of case b) and solved accordingly to the extent that the employment services to which the option relates have been rendered in one of the Contracting States so as to be taxable by that State under Article 15 because it is the State where the relevant employment is exercised. Indeed, in such a case, the State in which the services have been rendered will be the State of source for purposes of elimination of double taxation by the other State. It does not matter that the first State does not levy tax at the same time (see paragraph 32.8). It also does not matter that that State considers that it levies tax as a State of residence as opposed to a State of source (see the last sentence of paragraph 8).

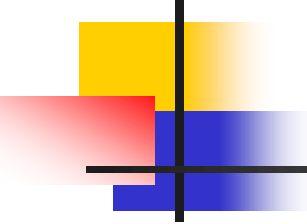
Example of issues in Cross-border taxation

Ex. 4 – Relieving double taxation

– cont'd – OECD commentary

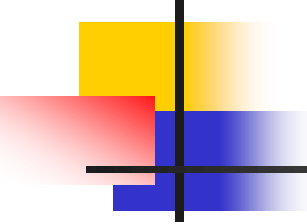
- **Paragraph 4.1 to 4.3 of the OECD Commentary on Articles 23A & 23B**

4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation and, as confirmed by the phrase "except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State" found in paragraph 1 of Articles 23 A and 23 B, any resulting double taxation will be outside the scope of these Articles. The mutual agreement procedure provided for in paragraph 3 of Article 25 could be used to deal with such a case. One possible basis to solve the case would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State. Thus, in the above example, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States.



FEMA - Applicability to ESOP issued by Indian Co. to foreign employees of subsidiary abroad

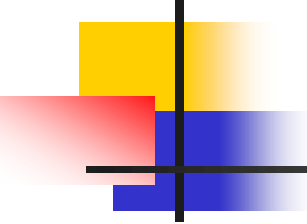
- ESOPs are specifically dealt with by Rule 8 of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 dated 17.10.2019 (“NDI Rules”)
- It permits an Indian company to issue “employees’ stock option” and/ or “sweat equity shares” to
 - its employees or directors or
 - employees or directors of its holding company or its joint venture or wholly owned overseas subsidiary or subsidiaries who are resident outside India subject to certain conditions
- The scheme should be drawn either in terms of regulations issued under the Securities and Exchange Board of India Act, 1992 or the Companies (Share Capital and Debentures) Rules, 2014, as the case may be
- The “employee’s stock option” or “sweat equity shares” so issued under the rules or regulations should be in compliance with the sectoral cap applicable to the said company
- An individual who is a Person Resident outside India (‘PROI’) exercising an option which was issued when he or she was a person resident in India, shall hold the shares so acquired on exercising the option on a non-repatriation basis



FEMA - Applicability to ESOP issued by Indian Co. to foreign employees of subsidiary abroad (cont'd)

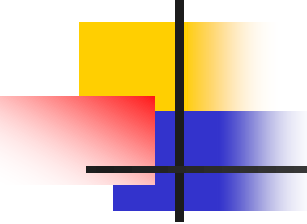
- **FEMA Reporting:**

At the time of Granting	Indian company issuing employees' stock option to PROI is required to file Form-ESOP, within 30 days from the date of issue of employees' stock option as stipulated vide Regn. 4(4) of the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019
At the time of exercise of Options i.e. issue / allotment of shares	Indian Company to obtain KYC of foreign employee File FCGPR online in 30days with RBI for the Foreign Investment
Valuation for exit in case of unlisted shares	Exit price can be any price less than or equal to fair value as determined by Chartered Accountant
Sale on stock exchange	To be reported by such person in Form FC-TRS as stipulated vide Regn. 4(3)(b) of the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019



FEMA - Applicability to ESOP issued by Foreign parent Company to employees of Indian subsidiary

- Under the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 issued vide Ntf. No. FEMA 120/RB-2004 dt. 07.07.2004, general permission has been granted to a person resident in India who is an individual –
 - to acquire shares under cashless Employees Stock Option Programme (ESOP) issued by a company outside India, provided it does not involve any remittance from India
 - to purchase equity shares offered by a foreign company under its ESOP Schemes, if he is an employee, or, a director of
 - an Indian office or branch of a foreign company, or
 - of a subsidiary in India of a foreign company, or
 - an Indian company in which foreign equity holding, either direct or through a holding company/Special Purpose Vehicle (SPV) irrespective of the percentage of the direct or indirect equity stake in the Indian company.
 - AD Category – I banks are permitted to allow remittances for purchase of shares by eligible persons under this provision irrespective of the method of operationalisation of the scheme i.e. where the shares under the scheme are offered directly by the issuing company or indirectly through a trust / a Special Purpose Vehicle (SPV) / step down subsidiary, provided (i) the shares under the ESOP Scheme are offered by the issuing company globally on a uniform basis, and (ii) an Annual Return is submitted by the Indian company to the Reserve Bank through the AD Category – I bank giving details of remittances / beneficiaries, etc.



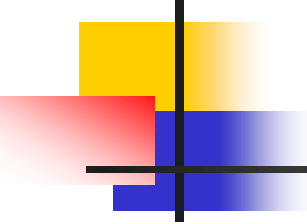
FEMA - Applicability to ESOP issued by Foreign parent Company to employees of Indian subsidiary (cont'd)

- Under the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 issued vide Ntf. No. FEMA 120/RB-2004 dt. 07.07.2004, general permission has been granted to a person resident in India who is an individual –
 - A person resident in India may transfer by way of sale the shares acquired as stated above provided that the proceeds thereof are repatriated immediately on receipt thereof and in any case not later than 90 days from the date of sale of such securities
 - Foreign companies are permitted to repurchase the shares issued to residents in India under any ESOP Scheme provided (i) the shares were issued in accordance with the Rules / Regulations framed under Foreign Exchange Management Act, 1999, (ii) the shares are being repurchased in terms of the initial offer document, and (iii) an annual return is submitted through the AD Category – I bank giving details of remittances / beneficiaries, etc.
 - An Indian company in the knowledge based sector may allow its resident employees (including working directors) to purchase foreign securities under the ADR/GDR linked stock option schemes subject to adherence to SEBI regulations in case of listed companies and to Govt. Guidelines in case of unlisted companies



SEBI Regulations for ESOPs - Overview

- Listed companies are governed by the Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 (SEBI SBEB Regulations) read along with SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
- The provisions of these regulations apply to following:
 - (i) employee stock option schemes;
 - (ii) employee stock purchase schemes;
 - (iii) stock appreciation rights schemes;
 - (iv) general employee benefits schemes; and
 - (v) retirement benefit schemes
- The provisions of these regulations apply to any company whose shares are listed on a recognised stock exchange in India, and has a scheme:
 - (i) for direct or indirect benefit of employees; and
 - (ii) involving dealing in or subscribing to or purchasing securities of the company, directly or indirectly; and
 - (iii) satisfying, directly or indirectly, any one of the following conditions:
 - a. the scheme is set up by the company or any other company in its group;
 - b. the scheme is funded or guaranteed by the company or any other company in its group;
 - c. the scheme is controlled or managed by the company or any other company in its group.

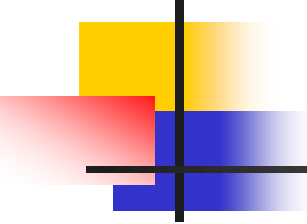


SEBI Regulations for ESOPs – Overview

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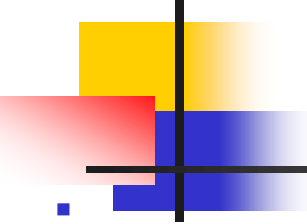
- Nothing in these regulations apply to shares issued to employees in compliance with the provisions pertaining to preferential allotment as specified in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

 - Employee means, —
 - (i) a permanent employee of the company who has been working in India or outside India; or
 - (ii) a director of the company, whether a whole time director or not but excluding an independent director; or
 - (iii) an employee as defined in clause (i) or (ii) of a subsidiary, in India or outside India, or of a holding company of the company
- but does not include—
- (a) an employee who is a promoter or a person belonging to the promoter group; or
 - (b) a director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten per cent of the outstanding equity shares of the company



Accounting for ESOPs

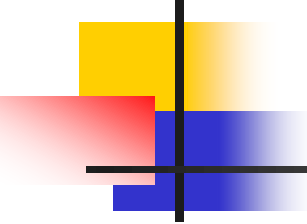
- The Companies Act, 2013 requires every company (listed or unlisted) to prepare its Books of Accounts as per the Accounting Standards as recommended by the Institute of Chartered Accountants of India (ICAI) from time to time as prescribed in accordance with Section 133 and Rule 12 of the Companies (Share Capital & Debentures) Rules, 2014, also requires compliance with the applicable accounting standards.
- Listed Companies have to ensure compliance with the SEBI Regulations. The SEBI (SBEB) Regulations 2014 under regulation 15 also require companies implementing any of the share based schemes to follow the requirements of the 'Guidance Note on Accounting for employee Share-Based Payments' (Guidance Note) or Accounting Standards as may be prescribed by the Institute of Chartered Accountants of India (ICAI) from time to time.
- Accounting of share based payment transactions is done in accordance with the reporting framework established by:
 - Guidance Note on Accounting for Employee Share Based Payments or
 - Ind AS 102 on Share Based Payment
- The corporate entities which are required to follow Ind AS or which have voluntarily adopted Ind AS cannot account for the share based payment based on Guidance Note.



Accounting for ESOPs - Cont'd

■ **Determining the Compensation Cost under ESOP**

- Method of Valuation:
 - The company has the option to choose either Fair Value Method or Intrinsic Value Method for determining the Compensation Cost. There is no difference in accounting procedure of the expense under both the methods.
 - The Guidance Note on Accounting for Share Based Payments issued by the ICAI, as applicable on the company, recommends that accounting for ESOP should be based on the fair value approach. However, intrinsic value method is also permitted under the guidance note.
 - As per Ind AS, services provided by employees are always measured by reference to the fair value of the equity instruments granted. Intrinsic Value has to be opted only if the fair value cannot be determined reliably.
- Measurement Date:
 - The Intrinsic Value/Fair Value has to be determined on the date of grant of options.
- Period of Booking:
 - The compensation cost is recorded in the books of accounts from the date of grant of the options up to the date of vesting of the options i.e. proportionately over the vesting period.
- Recognition of ESOP (Share Based Payments):
 - An entity shall recognize the compensation cost measured at the grant date fair value unless vesting conditions are not fulfilled. The compensation cost is accounted as an expense over the vesting period of the options during which the employee provides service to the company.

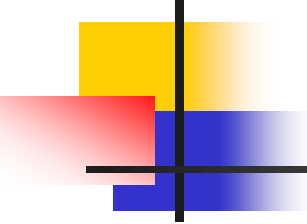


Employee Stock Options in USA - Overview

- In USA, companies can grant two kinds of stock options: nonqualified stock options (NQSOs), the more common type, and incentive stock options (ISOs), which offer some tax benefits but also raise the complexities of the alternative minimum tax (AMT)
- Many companies also have omnibus stock plans in which they are authorized to grant not only both types of stock options but also restricted stock, RSUs, performance shares, and stock appreciation rights (e.g. Uber's 2019 equity incentive plan).
- The table below summarizes and compares selected major traits of NQSOs and ISOs:

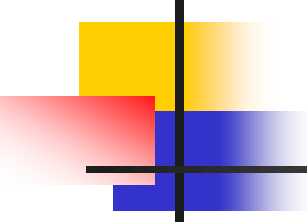
Option type	Eligibility	Event that triggers taxes	Taxes	Withholding?	Tax at sale
NQSOs	Company employees, executives, directors, contractors, and consultants	Exercise	Ordinary income tax, Social Security, and Medicare on the exercise spread	Yes, at exercise	Capital gains tax
ISOs	Only company employees and executives	Sale, unless AMT incurred	Ordinary income tax, AMT, or none*	No	Capital gains tax*

*ISO taxation depends on: (1) when shares are sold; (2) the sale price relative to the exercise price and the market price at exercise.



Employee Stock Options in UK - Overview

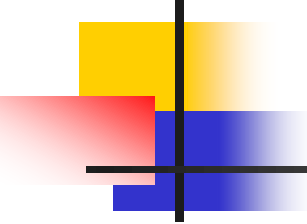
- Four HMRC approved share option schemes available in UK are:
 1. Share Incentive Plan (SIP)
 2. Save as you Earn (SAYE)
 3. Company Share Option Plan (CSOP)
 4. Enterprise Management Incentive (EMI)
- The first two of these, SIP and SAYE, are relatively low value schemes which are usually only used by very large organisations to incentivize a sizeable workforce. Where adopted, these schemes must be made available to all employees, including part-time employees who should be treated in the same way as full-time employees on a pro-rata basis.
- The CSOP and EMI schemes are discretionary schemes allowing a significant award of share options with more favourable tax treatment than unapproved Schemes



Employee Stock Options in UK – Overview

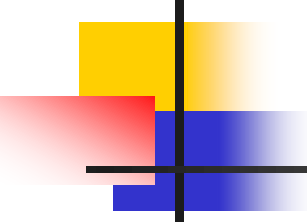
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- SIP: A company is entitled to provide each employee with “free shares” up to a value of £3,600 per year with no income tax consequences. Free shares can be awarded by reference to an employee’s pay grade, performance, length of service, or hours worked.
- SAYE: Under the scheme, employees are granted options to buy ordinary, fully paid and unrestricted shares (including voting rights) after three or five years’ of service with the company at a discount of up to 20% of the current market value. If the minimum option period of three years is observed, there is no Income Tax charge on the grant or exercise of the option. Companies will receive Corporation Tax Relief on the cost of establishing and administering the scheme, and at the date on which shares are issued.
- CSOP: These are discretionary as the employer company can choose which employees and directors it wishes to reward. The maximum option-value is £30,000 per employee based on the market value at the date of the grant. The option period must be between 3 and 10 years. Income Tax and NI are not due when the option is granted or exercised, making this scheme very tax efficient. Capital gains tax is payable on sale of shares.
- EMI: This scheme allows for up to £3 million of company share options to be granted to employees. Individual employees may each be granted options up to a market value of £250,000. The chief benefit of using an EMI Scheme is that no Income Tax or National Insurance (NI) contributions are charged on the grant of EMI options, and, there will also be no Income Tax or NI charge at the point of Exercise, provided that (i) the exercise price is at least equal to the market value at the date of grant, and (ii) the options continue to qualify until the date of exercise (which must be within ten years from the date of grant)



Employee Stock Options in Singapore – Overview

- Singapore has two kinds of Employee Share ownership plans – (i) Employee Stock Option Plan (ESOP) where employees have the rights to purchase company's shares at a pre-determined price within a specific period of time, (ii) Employee Share Ownership Plan (ESOW) which allow an employee of a company to own or purchase shares in the company or in its parent company. They include share awards and other similar forms of employee share purchase plans. It excludes phantom shares and share appreciation rights
- **Tax Implications**
- Company:
 - A company with ESOP is eligible for tax deductions on costs incurred to acquire its own shares (i.e. treasury shares) applied for the benefit of employees. The timing for the company to be allowed tax deduction is when the shares vest to the employees. For ESOP, this typically occurs when employees exercise their stock options.



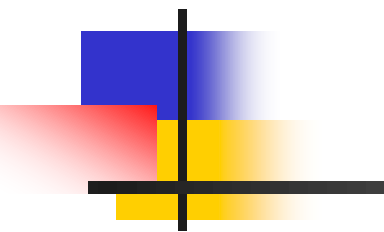
Employee Stock Options in Singapore – Overview

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- **Tax Implications**

- Employees:

- An employee who is granted share options by the employer will be taxed on any gains or profits arising from the exercise of the share option. The timing of taxation is based on when the share option is exercised or when the selling restriction has been lifted. The amount of taxable gain is the difference between the open market price of the shares at the time of exercise/selling restriction has been lifted and the amount paid by the individual for such shares.
- For gains arising from an ESOP with no selling restriction, it is taxable in the year when the share options are exercised. For ESOP with selling restriction, gains generated from the ESOP will be taxed only in the year when the selling restriction is lifted.
- There is a “deemed exercise” rule for foreign employees when they cease Singapore employment. Under “deemed exercise” rule, the foreign employee is deemed to have derived a final gain when he ceases employment in Singapore on unexercised ESOPs or ESOPs where the selling restriction has not been lifted. Final gains are deemed to be income derived by the individual one month before the date of cessation of employment or the date the right is granted, whichever is the later.
- Tax deferment option: Subject to qualifying conditions, employees can choose to defer the payment of tax (subject to an interest charge) on the gains from ESOP for any period of time (e.g. 2 or 3 years) up to a maximum of 5 years. The tax-deferred and interest charged will become due on the expiry of the deferral period.



Thank You
