Fringe Benefit Tax, The Miracle Cure or the Dreaded Demon!

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The Finance Act, 2005, introduced the Fringe Benefit Tax (FBT) on employers, which is payable on the value of certain 'fringe benefits'. In his speech, the Finance Minister indicated that the objective behind the introduction of this tax was to bring within the tax net, the many perquisites disguised as 'fringe benefits', on which neither the employer nor the employee pays tax.

In the recently issued Circular[1] (which will be discussed in some detail later) the intention of taxing fringe benefits has also been sought to be justified on the ground that it will bring about parity of taxation between employees in the middle and lower managerial levels, who are generally not provided with fringe benefits, and top management who do normally have such benefits provided to them. It is also thought that this tax will put employers on a level playing field by reducing discrimination between employers who provide and those who do not provide such fringe benefits and pay a cash salary to their employees.

In the light of the above, it would be interesting to break-up and analyse the definition of 'fringe benefits' in the Income-tax Act, 1961, (the Act)[2] to see if the intentions have, in fact, been achieved.

Fringe benefits have been defined to include *inter alia*

1. privileges, service, facility or amenity directly or indirectly provided by an employer;

2. any free or concessional ticket provided by the employer for private journey;

3. any contribution by the employer to an approved superannuation fund for employees;

4. certain other costs incurred by the employer e.g. sales promotion, conference expenses, gifts etc, which are, deemed to be fringe benefits provided to the employees.

In keeping with the first objective, it is not difficult to understand the items at serial No.(1) and (2) being brought within the FBT net. However, it is difficult to understand and comprehend why expenses like sales promotion or corporate gifts which do not provide any benefits to the employees should have been roped in. Though question no. 2. of the Circular does say that an employer-employee relationship is a pre-requisite for the levy of FBT this question has not been answered specifically by the Circular.

Now lets look at whether the other objective of bringing parity amongst the different salaried class has been achieved.

From a glance at Table-1 table it appears that the intention to bring uniformity amongst the employees has been achieved albeit at the cost of the employer!

The introduction of FBT caused a lot of anxiety & concern to corporate India as it clearly impacts all corporates and results in an increase in the cost of doing business. It, therefore, necessitated every company to analyse:

- The overall impact of FBT on its costs
- The extent to which such increase is on account of employee costs.

This needed to be followed up with:

- Setting up appropriate FBT compliance mechanism: and
- Possible redesigning of compensation structure within the legal framework.

[1] *Circular No. 8/2005 dated 29 August 2005 issued by the Central Board of Direct Taxes (CBDT).*

[2] *Section 115WB of the Act.*

Table - 1

	CTC of Rs. 500,000			CTC of Rs. 1,000,000			CTC of Rs. 1,500,000		
Component	**CTC**	**Pre FBT**	**With FBT**	**CTC**	**Pre FBT**	**With FBT**	**CTC**	**Pre FBT**	**With FBT**
Basic salary	225,000	225,000	225,000	450,000	450,000	450,000	675,000	675,000	675,000
Provident Fund Contribution	27,000	-	-	54,000	-	-	81,000	-	-
Superannuation Fund	33,750	-	-	67,500	-	-	101,250	-	-
Taxable allowances	154,250	154,250	154,250	213,500	213,500	213,500	340,750	340,750	340,750
Fringe Benefits									
Food coupons	12,000	-	-	18,000	6,000	-	18,000	6,000	-
Telephone	12,000	-	-	20,000	-	-	30,000	-	-
Car maintenance including driver's salary	-	-	-	120,000	26,400	-	180,000	26,400	-
Books and periodicals	12,000	12,000	-	18,000	18,000	-	24,000	24,000	-
Entertainment	12,000	12,000	-	24,000	24,000	-	30,000	30,000	-
Electricity	12,000	12,000	12,000	15,000	15,000	15,000	20,000	20,000	20,000
Taxable income		415,250	391,250		752,900	678,500		1,122,150	1,035,750
Employee's tax liability		76,067	68,723		179,387	156,621		321,616	292,533
Reduction in employee tax liability			**9.65%**			**12.69%**			**9.04%**
Employer's FBT liability			**13,784**			**34,973**			**51,853**
Total tax (individual + employers)			82,506			191,594			344,387
However, increase in total liability			**8.47%**			**6.80%**			**7.08%**

Employer pays FBT on Superannuation Fund contributions, Telephone reimbursements, motor car expenses, books and periodicals and entertainment expense reimbursements.

Electricity expense reimbursement continues to be taxed in employee's hands.

There were a host of unanswered questions regarding the interpretation of the provisions, *inter alia,* on whether FBT was only employer-employee relationship specific tax; its applicability to foreign companies, possible meaning of the terms used in FBT etc. To try and clear the confusion, CBDT had assured that a Circular, giving direction and understanding to the taxpayers would be issued, which was done on 30 August 2005 vide Circular No.8/2005 dated 29 August 2005.

The Government must be lauded for issuing a comprehensive example oriented circular throwing light on various grey areas and confusion in the minds of the taxpayers. This is definitely a welcome practice, which is followed by the Internal Revenue Service of United States which regularly provides detailed clarifications on new legislation.

The Circular clearly is indicative of the Government's thinking and also gives a clue on how the assessments will be formed. However, it is also debatable whether the Circular has the power to extend the scope of the legislation or give direction on taxability of income. E.g. it has been clarified that interest on loans taken for purchase of motor cars will fall under "repairs, running and maintenance of motor cars". It is not clear how this can fall within any of the terms used. It has also been stated that surplus of per-diem allowance will not be taxed in the hands of the employees. Can a Circular, explaining the provisions of FBT, deal with taxation of individuals? Also, when the essential pre-requisite for the levy of FBT is an employer-employee relationship, the clarification that FBT is payable on the entire expenditure incurred under the specified heads and not merely on expenditure pertaining to employees is bound to be challenged in a Court of law. Circulars, it must be remembered are binding on the tax officers but are not binding on the taxpayers to the extent they are prejudicial to them. It would be noteworthy to see the view taken by the Supreme Court on this issue. The Supreme Court in the case of *State Bank of Travancore v. CIT [1986] 158 ITR 102 (SC)* held that Circulars which are executive in nature cannot alter/enlarge the provisions of the Act. In the case of *CIT v. Hero Cycles (P.) Ltd. [1997] 228 ITR 463 (SC)* the Supreme Court has held that Circulars can bind the ITO but cannot bind the appellate authority or the Tribunal or even the assessee. Therefore, it is still open for the taxpayer to challenge the provisions of FBT and the dictates of the Circular to the extent that they feel they are prejudiced by it.

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It was recently reported that a firm of Chartered Accountants has challenged the constitutional validity of FBT in the Madras High Court. We understand that the constitutional validity has been challenged on the following grounds:-

1. It violates the following provisions of the constitution.
   i. Article 14 - Equality before law
   ii. Article 19 - Right to Freedom – profession
   iii. Article 265 - No tax without authority of law
2. It amounts to double taxation as no deduction of expenditure is allowed.
3. It discriminates between different categories of employers.
4. The cost of administration would be heavy.
5. It is against the basic concept of income-tax law
6. It is without any rationale.

Considering the opposition and the large degree of concern in the corporate sector on being burdened with another levy which not only directly increases the cost of doing business but also increases administrative workload, other Court battles are sure to follow soon.

The controversy surrounding the definition of Fringe Benefits also remains on many issues such as sales promotion. The contribution to superannuation funds, which continues to remain in the definition of FBT, is perhaps the cruellest blow of all. We shall take a brief look at some of the items of controversy.

Applicability of FBT

Considering that the process of winding up a company is a lengthy and time consuming one and the fact that there is no business carried on, the companies which have practically closed down and are in the process of winding up should not have been burdened by FBT.

The Circular clarifies those entities not having employees on their payroll (eg. Law firms having retainer-relationship arrangements and no employees) will not be liable to FBT. Though retainer-relationship arrangements might work for law firms they may not work for other professionals and therefore employers should avoid from resorting to such arrangements.

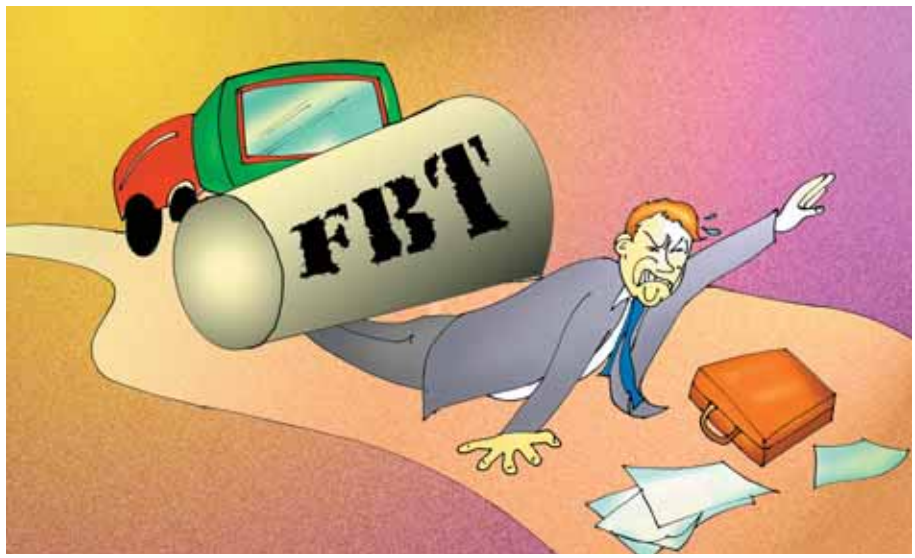
Contribution to Superannuation Funds

The whole purpose of introducing FBT was to capture perks/ benefits which could not be identified to a particular employee. In the case of superannuation which is so identifiable, the intention seems to be defeated. In a country where social security benefits are conspicuous by their absence, post-retirement benefits like superannuation are a safety net. With FBT, some restructuring of pay packages will definitely follow and if employers decide to stop funding superannuation, it will have a ripple effect not only on employees but also on Funds with whom the companies would have invested and on the markets if the Funds decide to dilute those investments. Perhaps, this is one area, which the Finance Ministry should revisit.

Sales Promotion

The FM had promised to keep legitimate business expenses out of the FBT net. To this end, the definitions of sale promotion and conference expenses were substantially amended, as compared to the provisions when introduced in the Finance Bill. However, the objective to keep legitimate expenses out of the net does not seem to have been completely achieved especially considering that the employee does not get any benefit from a publicity campaign, for eg. If a corporate decides to sponsor a tennis or a golf tournament, what is the benefit fringe or otherwise to the employee? The rationale behind exempting event sponsorship only undertaken by Government and trade bodies also does not seem too clear.

The Circular has drawn a distinction between sales promotion and selling costs.



Brokerage or selling commission paid to direct selling/ marketing agents is clarified as part of ordinary selling expenses. Also, sales discount to wholesalers and customers are identified as reduction in sales price. Hence, it is clarified that FBT is not applicable to these expenses. However, reasoning behind saying that expenditure on art work on free offers to trade or customers (excluding employees) will be liable to FBT is again not very clear.

Surprisingly, payments for use of brands, or to brand ambassadors and for celebrity endorsements have been considered as sales promotion. This defeats the objective of restricting the tax to employer-employee related expenses. If say Britannia hires Mr. Rahul Dravid to promote its products, how and why should the employees care or be concerned, and more importantly, what say does the employee have in these decisions? The Circular also clarifies that expenditure on distribution of free medical samples distributed to doctors and any expenditure on free samples of other products distributed to trade or consumers will be liable to FBT. Again it is not very clear how the employee stands to benefit from the distribution of free samples? The employee does not have any say in the incurring of these costs and it would therefore be very unfair to push the tax on these costs into the restructured salary packages. Most employers, being conscious of this would not push these onto employees; however, this makes planning and administering FBT impact even more challenging. In today's times, when the endeavour is to cut down on litigation this tax is going to give rise to a lot of litigation on interpretation of several issues. Even in a presumptive tax regime, such items should have been excluded from fringe benefits..

Conference Expenses

Conference is another example of business expense from which the employee does not derive any direct benefit. The FM should recognise that competing globally requires high profile networking and conferences are necessary business expenses which should have been excluded. Some respite though has been given by excluding fees paid

for attending conferences. Does this mean that organisers should keep the fee charge slightly higher rather than have a separate charge for the cost of stay and food? Rather than give rope for these unnecessary and litigious actions, it would have been, perhaps, wiser to exclude such expenses altogether.

The rationale behind the concessional rate seems to be that in these industries extensive travelling is required. The BPO industry also requires the employees to travel and spend time away from their families. The BPO industry has put India on the global map, more so than ever before, and along with IT is considered to be the industry that will push India into a superpower status. Therefore, this still relatively nascent industry should also be given reliefs.

Concessional Rates

There have been concessionnal rates prescribed in case of employers engaged in the business of construction, manufacture, or production of software/pharmaceuticals on conveyance, tour and travel and hotel expenses; however, no definition of what constitutes production of pharmaceutical/software had been stated. The Circular has thrown light on the term "computer software" to mean "recording of programmes on any disc, tape or perforated media or other information storage devices. This would exclude information technology enabled BPO services from the concessional valuation. Considering that IT and IT enabled services go hand in hand in other legislations like Customs law, as also in the Income-tax itself in other provisions like section 10A/10B, perhaps, in the FBT provisions also they may be put on par.

Recently, the 'Business Line' (Hyderabad, 30 August 2005) reported that 'Aamoda Publications Private Ltd,' who prints and publishes the leading Telugu daily 'Andhra Jyoti' and weekly 'Navya', moved the Andhra Pradesh High Court contesting against the arbitrariness of the tax. They argued that some sections in the tax violated Article 14 and 19 (1) (g) of the Constitution.

The petitioner contended that the value of the fringe benefits fixed for various categories of expenses varied for certain businesses. Business such as pharmaceuticals, software, construction, hotels, transport and aircraft had been given concession, this was totally arbitrary, based on surmise and was highly discriminative. For one, the value of fringe benefit for expenditure on conveyance, tour and travel for employers engaged in construction, manufacturer of pharmaceuticals and software was five per cent.

The Andhra Pradesh High Court has directed the Income-Tax Department to accept advance FBT at the five per cent rate and not at 20 per cent from publishers till further orders to be passed on the petition.

This is a good example of the plethora of litigation and constitutional challenges that will follow as a result of this levy being imposed on companies who are anyways working on very slim profit margins in the globally competitive environment.

Employee Welfare and Provision of hospitality

The definition of employee welfare expenses excludes expenses on "mitigating occupational hazard". These are subjective terms capable of varying interpretations. If an employer provides his miners a helmet, with a torch on it to wear, while they are working in the mines would it amount to cost incurred for "mitigating occupational hazard"?

The interpretation given by the Circular that Medical Expenses upto INR 15,000 would be covered within the FBT net though perhaps correct as per the law as it stands today, considering that there is not much scope for tax planning for the salaried class, a specific amendment may be introduced to exclude such payments from FBT. Further, it may also be clarified that if the cost of treatment, in an unapproved hospital, paid by the employer, is taxed in the hands of the employee, as perquisite, it will not again be liable to FBT in the hands of the employer.

The Circular also clarifies that if the employer reimburses the cost of food or beverages, on account of late sitting, that would be covered within FBT. However, if the employer directly procures the food there is no liability for FBT. Reimbursement, being only a matter of convenience in arrangement of the payment, it would be only fair that either which way there ought to be no liability to FBT.

In the case of training provided to employees the Circular clarifies that when the employer provides the training in a training centre, owned by him, the expenditure on food and beverages provided at the training centre will not be liable to FBT as the training centre is regarded as an 'office or a factory'. However, when the training is provided in a centre hired for the purpose it cannot be regarded as an 'office or a factory' and therefore, the expenditure on food and beverages would be liable to FBT. It is also clarified that expenditure on in-house training would not be liable to FBT as 'conference expenses' however, expenditure on food and beverages, tour and travel and lodging and boarding in connection with such in-house training would be liable to FBT. Training is an important means used by the employer to groom the employees, to understand the organisation's functional methods and requirements as well as, to face the global competition etc. Training is absolutely imperative in today's fast changing and constantly evolving business world. Therefore, irrespective of where the training is held, all expenditure in connection with training ought to have been left out of the FBT net. Further, the reasoning behind excluding expenditure on food and beverages, from FBT, only if the training is at an exclusively owned training centre and not any place else does not seem very justified when the end result sought to be achieved is the same.

Another example, which may be expanded on is; the exception under 'hospitality' on paid food vouchers which are "not transferable and usable only at eating joints or outlets." What is to be classified as an "eating joint" and further how is the employer to control where the voucher is encashed has to be clarified.

Most employers propagate that 'employeees are the true wealth of an organisation', it will be interesting to observe how employers balance continued employee motivation and reward in the face of FBT.

Festival Celebrations

Expenses on festival celebrations have also been brought into the FBT net. At times, for certain festivals, the employer is forced to contribute by the "organisers". Here again there is no benefit to the employee when the employer is forced to contribute to some *"mandal"*.

Further, celebrations like annual day (non-festival celebrations) may also be grouped under 'employee welfare'. These expenses are again incurred with a view to boost employee morale and are open to all and therefore, they do not seem to be in line with the objective of FBT to bring parity or; to bring hitherto untaxed 'fringe benefits' to tax. Fundamentally, any expense, in the incurrence of which the employee has no say, should be left out of the FBT net, as, ultimately, in one way or the other the final burden will be pushed on to the employee.

Foreign Companies Liaison Offices

The introduction of FBT had raised several questions on whether the tax was extra

territorial. India, being a sovereign State, has the authority to impose a tax on any person deriving income from its territory.

It has been clarified that foreign companies including liaison offices and foreign employers whose income is exempt, would be liable to FBT if they have employees based in India. The term *"based in India"* has not been expanded. Can the tax authorities take an extreme view that foreign companies, whose expatriates are on their payroll only for administrative convenience, but work solely for the multinational group's Indian entity, will be subjected to FBT though, the employee is not physically based in India? What are the benchmarks that will be used to determine "*based in India*"; the nature of his visa, frequency of his visits, duration of his stay can be useful indicators.

Foreign Tax Credits (FTC)

The circular very candidly says that FTC will be available subject to the provisions of FBT. However, would FBT be considered a tax on income for the purpose of tax credits by the other State? Of course, it could be argued that it is considered as additional income-tax under the Indian tax laws and should therefore be allowed. The way out may be for India to renegotiate its tax avoidance agreements in the line of New Zealand-Australia tax treaty where, double Fringe Benefit taxation is avoided as the country having the right to tax the employee is given the right to levy FBT. However, it must be pointed out that FBT in these regimes are on employee related benefits only whereas, in the Indian context FBT is to be paid on a variety of business expenses.

Exemption being claimed under the Dependent Personal Services clause

The Circular has clarified that where all the employees of a foreign company are not taxable in India due to dependant personal services article of the applicable DTAA, the foreign company would not be liable to FBT. However, even if a single employee is taxable in India, the entire expenditure would be subject to FBT. This variation seems to be too drastic. Perhaps a sensible approach to apportion the expenses on the basis of taxable and exempt employees would have been advisable.

Indian companies with overseas operations vis-à-vis foreign companies having Indian operations

In respect of Indian companies with overseas operations the circular clarifies that FBT would be levied only in respect of the expenses attributed to the Indian operations whereas the fringe benefits attributed to the foreign operations are not to be taxed. Where no separate books of account are maintained in respect of overseas operations the apportionment is to be done on the basis of proportion of employees working in and outside India. Questions would arise as to how such proportion is to be worked out where a number of persons are working in and outside India only for the part of the year in India. Further, where the expenditure say on travelling, which would form the bulk of it can be identified, can the actual be considered? However, all said and done this is a relief provision and should be welcomed by the Indian companies with overseas branches.

However, where an Indian permanent establishment of a foreign company is claiming deduction of expenses overseas, of the nature deemed to be covered under 'fringe benefits' and these expenses are attributable to the Indian operations, FBT is to be levied on such overseas expenses. When we are constantly talking about encouraging foreign investment why the inconsistency in the treatment of a foreign branch of the Indian company, which is sought to be exempted from FBT on overseas expenditure, and the treatment of a PE of a foreign company? This will also definitely affect foreign branches which are claiming a deduction under Section 44C for expenses incurred by head office outside India attributable to Indian operations to the extent covered within FBT provisions.

Conclusion

In conclusion, FBT will not only increase the ultimate cost of doing business but will also provide logistical nightmares for companies to maintain detailed records of expenses and increase the cost of compliance which is contrary to the FM's focus on simplification. The reduction in rates from the rates proposed in the Finance Bill is a positive sign but if taxpayer's experience with service tax, which started at 5% and has increased to 10%, and with Securities Transaction Tax which have also increased within a year from when it was introduced, is anything to go by that relief may also soon be short lived. Its best though that companies come to terms with the fact that FBT is here to stay. However, it would be easier to make peace with it if a few of the issues listed above were tackled effectively. ❐