Modifications in Provisions of FBT, TDS & Penalties

This Article deals with the three areas touched upon by the Finance Bill 2007 viz. modifications proposed in the provisions dealing with taxation of fringe benefits, tax deduction at source and penalties imposable under the IT Act. All these provisions have been considered to be part of the Rationalisations as mentioned in the Memorandum explaining the provisions in the Finance Bill 2007. This categorisation is at times debatable.

Modifications in provisions relating to Fringe Benefit Tax (FBT)

The relaxation granted in regard to expenditure relating to display, and free samples may correctly be described as rationalisation. However, the rationale of proposals bringing to tax employee stock options (ESOPs) as fringe benefits under a scheme of rationalisation seems difficult to comprehend.

For this we need to look at the chequered history that ESOPs have had. Initially, when ESOPs were introduced in India as a new mode of remuneration / incentive, there was some doubt about whether the same could be brought under tax and whether such incentives constituted a taxable perquisite. These doubts were set to rest by an amendment in S.17, which expressly provided that ESOPs would be considered a part of the perquisites and also provided a methodology for bringing the same to tax. However, considering the numerous practical difficulties that were encountered, ESOPs were later removed from the definition of perquisite.

However, the intention to bring ESOPs into tax net was not entirely abandoned by the Ministry. Accordingly, an amendment is proposed in Section 115 WB (1), whereby a further category of fringe benefits is introduced. The proposed Clause reads, "(d) any specified security or sweat equity shares allotted or transferred, directly or indirectly by the employer free of cost or at a concessional rate to his employees, (including former employee of employees)"

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It is evident that allotment of ESOPs to an employee is ultimately for the commercial benefit of the company itself. However, the rationale cited by the Finance Minister for introducing fringe benefit tax was to bring into the tax net, items, which clearly amounted to benefit to an employee where the specific benefit could not be identified to any individual but resulted in the collective benefit to the employees, while also allowing a deductible expenditure to the company. When applied to ESOPs, there is no element of ambiguity or collective benefit in vesting of ESOPs. The recipient of benefit in the case of ESOPs is clearly identified. Further, the grant of ESOPs does not result in a revenue expenditure in the hands of the company. The ESOPs, therefore, clearly do not fall within the criteria mentioned for bringing to tax an item as a Fringe Benefit. The question of determination of value of the benefit may indeed be problematic but this issue has to be addressed irrespective of whether ESOP is taxed as a perquisite or as a Fringe benefit.

Thus on the face of it, bringing ESOPs to tax as a fringe benefit does not seem to meet the basic criteria that were cited by the Hon'ble Minister in introducing fringe benefit taxation. However, the policy decision to tax ESOPs as a fringe benefit having been taken, we may examine the impact of the proposed provisions.

Clause (d) reproduced above indicates that the point of crystallisation of charge arises at the time of allotment or transfer of the ESOPs by the employer. In the numerous schemes that are in vogue for vesting of ESOPs it is seen that

usually the process can be divided into the offer being made by the company (which includes certain conditionalities to be complied with by the employee in order to qualify for the benefit), the fulfillment of the conditions prescribed, the vesting of the right to exercise the option, the actual exercise of the option by the employee and the transfer by the company of the shares or beneficial interest therein.

Earlier there was considerable debate as to what point of time would be treated as the point of taxability. This issue has been clearly dealt with by the proposed provisions, which prescribe the last of such process viz. the transfer or allotment of the shares for the benefit of the employee is the point of taxation. The further benefit if any that may be gained by the employee upon appreciation of the said shares received by him as an ESOP is also to be brought to tax. This, however, would be as a normal part of the capital gains taxable in the hands of the employee. In fairness, the value on which the company transferring the ESOP to the employee has paid fringe benefit tax is treated as cost of the said shares in the hands of the employee.

However, in prescribing the manner of computing the value of the benefit, Section 115 WC has prescribed that the fair market value of the specified security or sweat equity shares shall be deduced on the date of exercise of the option by the employee. As mentioned in the preceding paragraph, the date of exercise of option could be different from the date of transfer or allotment. In practice, usually the date of exercise of option would always precede the date of transfer or allotment. Problems could arise if the value of the security/shares at the date of the taxable event (transfer or allotment) varies significantly from the date on which the value is determined.

The explanation to Sec. 115 WC (ba) further adds that the value to be considered for the purpose of computation of fringe benefit shall be determined in accordance with a method as may be prescribed by the Board and fringe benefit tax is computed and paid by the employer thereon.

It is also important to note that since the taxation of ESOPs have been inserted in Section 115 WB (1), there is no rebate in the value as determined. Accordingly, fringe benefit tax will be payable at the normal rate on the entire value of fringe benefit so determined. Thus, if the value of the benefit is determined at Rs. 100, the fringe benefit tax payable (inclusive of surcharge and education cess) would be Rs. 34. It is also important to note that since the expenditure incurred on payment of fringe benefit tax would amount to payment of "income tax" within the meaning of Section 36, the amount of Rs. 34 paid as mentioned above would not be an allowable expenditure. As such, the effective rate of tax payable if one considers the non-allowability of the tax works out to Rs. 51 on a fringe benefit value of Rs. 100. Given the above calculation, it is to be seen whether ESOPs would continue to remain an effective tool for providing an incentive or perquisite to employees. Considering the tax related issues arising from grant of ESOPs, it may be simpler for employers to grant an incentive by way of an actual payout to an employee. Such incentive may be linked to the price appreciation of the equity shares as per a certain agreed formula.

Certain other related issues that may be mentioned but which will become more academic in view of what is mentioned above are:

- the applicability of fringe benefit arises out of any transfer or allotment, directly or indirectly by the employer
- in the event of part of the cost being recovered from such person by the employer, the amount recovered from the employee is deducted from the fair market value determined in accordance with the Section 115 WC(ba).
- The allotment contemplated for the charge of fringe benefit tax to arise would be in regard to specified security or sweat equity shares being transferred or allotted to former employees also.

A word of caution may be appropriate that the use of the words "directly or indirectly" may result in many transactions, which were never intended to be covered under the scope of fringe benefit being hit by the language of the newly inserted Clause. Transactions of family arrangements,

mergers and demergers between persons who are allotted / transferred shares under such a scheme (and who are also employees/ former employees) of the Company may attract FBT U/S 115 WB (d) due to the wide sweep of the words "directly or indirectly" although such transactions may not be intended to be covered as ESOPs.

While pointing out the possible danger, it is also necessary to note that unless the word indirect were used, schemes where ESOPs were given in regard to the equity shares of a parent company by the Company whose employee is the beneficiary of the scheme are fairly common. It would be iniquitous not to bring such ESOPs under the tax net, and therefore the use of the word "indirect" may be necessary in order to cover such situations.

The exclusion of proviso to S.17(2)(iii) also needs to be noticed, for the possible unintended effect it may have of bringing the ESOPs to taxes not only as a fringe benefit in the hands of the employer, but also as a perquisite in the hands of the employee. This is because, the removal of a specific exclusion could lead to the conclusion that ESOPs are now included in the definition of perquisite. The general exclusion from within the meaning of perquisites, of items that have been taxed as fringe benefit, provided in clause (vi) may not be relevant. This is because if an item is considered as a perquisite under clause (iii) the fact that cl (vi) does not apply may be irrelevant. Some clarification in this regard, preventing double taxation of items already brought to taxes as fringe benefits may be in order.

Expenditure on display of products & distribution of samples

S115 WB(2) deals with various expenses incurred by the employer which are deemed to be fringe benefit. Clause D of sub-section 2 applies to sales promotion and publicity expenditure. However, by way of a proviso, various items are excluded from the scope of sales promotion and publicity expenditure. In response to the demand from various quarters of industry, the expenditure on display of products has also now been excluded from the scope of advertisement and publicity expenses. This exclusion is made effective from 1st April 2006, and will accordingly give immediate relief to retailers who may have significant expenditure under this head. Similarly distribution of samples either free of cost or at a concessional rate has been excluded from the concept of sales promotion and publicity expenditure.

Advance tax on fringe benefits

Another change that has been brought about is in regard to the advance tax in respect of fringe benefits. The earlier Schedule of payments prescribed by Section 115 WJ required payment of advance tax on fringe benefits to be made on or before the 15th day from the end of the respective quarter. In regard to fourth-quarter, the requirement was to pay by 15th of March. This has been modified to bring the date of payment of advance tax on fringe benefits in harmony with the requirements of payment of advance income tax as prescribed by Section 211. The particulars in this regard, which will apply to Assessment year 2008-09 are brought out in the following table.

Due Date of Payment	Extent of Payment	
	Company	Non-Company
15th June	15% of total FBT	Nil
15th September	Upto 45%	30% of total FBT
15th December	Upto 75%	Upto 60%
15th March	Balance	Balance

Modifications in provisions relating to TDS

Proposed rationalisations and fine-tuning in regard to TDS provisions are as follows:

S. 193: 8% Savings (Taxable) Bonds 2003 have hitherto been outside the ambit of TDS since they are Government securities and hence excluded from the application of Section 193. This exclusion is now being removed if the interest received from these bonds in a financial year exceeds Rs. 10,000.

S.194A: The threshold limit for deduction of TDS by banks and cooperative banks in respect of 'interest other than interest on securities' paid to the depositors is presently Rs. 5000. The same is now raised Rs. 10,000 for a financial year. This would significantly reduce the burden of deduction of tax from small depositors. Simultaneously, Section 206A has also been amended to provide a similar increase in threshold limit for filing of returns, Form 15G /15 H in such cases. The threshold limit for assessees other than banks and cooperative banks continues unchanged at Rs. 5000.

194 C : The provisions relating to deduction of tax from sub-contractors were extended to apply to certain individuals and HUFs from 1st June 2002. A similar extension of liability to such individuals and HUFs was not made at that point of time. This anomaly has been set right by the proposed amendment, thereby bringing the position of contractor's and subcontractors on par. Suitable clarification excluding payments of a personal nature has also been introduced to remove ambiguity in this regard. Thankfully, this provision has been made only prospectively applicable.

Simultaneously, Section 206A has also been amended to provide a similar increase in threshold limit for filing of returns, Form 15G /15 H in such cases.

194 H & 194 J: The rates of deduction of tax in both these provisions have been enhanced from 5% to 10%. The tax deduction on commission, brokerage and fees for professional or technical services will thus be doubled with effect from 1st day of June 2007. An exception has been carved out in regard to commission or brokerage payable by BSNL & MTNL to their public call office franchisees.

194 I: As part of the rationalisation exercise, the TDS rate on hire of machinery, plant or equipment is reduced to a flat rate of 10% instead of the differential rate of 15/20%prevalent earlier.

The TCS provisions of Section 206 has been amended to exclude mining and extraction of mineral oil and natural gases

The methodology of computation of interest under Section 201 has also been modified to make the applicable rate 1% for a month of part thereof instead of 12% per annum, giving the revenue collection a slight edge in interest computation.

Modifications in provisions relating to penalties

The two major changes in Penalty provisions are inter-related and deal with the penalty in regard to concealed income. The major change proposed is to bifurcate the provision applicable in cases of search u/s 132. The existing process of concealment penalty u/s 271 (1) (c) is continued in regard to periods preceding date of search with certain modifications. This is done by introducing explanation 5A to S. 271 (1) (c) with effect from 1st June 2007 (in place of Explanation 5 which will cease to operate from that date).

To supplement this; a new Section 271 AAA is introduced. This section has a limited field of application. It provides for a penalty of 10% of undisclosed income (in contrast to 100% to 300% of the tax sought to be evaded – S. 271 (1) (c). This provision, however, applies to the undisclosed income pertaining to a maximum period of 2 years, which would fall within the "specified previous year". This period would cover -

(i) A previous year which has ended prior to the date of search but for which the due date for filing of return has not expired before the date of the search and the assessee has not furnished the return of income for the previous year before the said date.

(ii) The previous year in which the search was conducted.

To illustrate; if a search were conducted on 5th June 2007 (i.e. after the amended provision come into force) the previous year 2006-07 would be included in 'specified period' per clause (i) above. The previous year 2007-08 would be covered as per clause (ii) above as search is conducted in

that previous year.

Penalty u/s 271 AAA would therefore be leviable in regard to undisclosed income relating to A.Y. 2007-08 & A.Y. 2008-09 in the above illustration (i.e. @ 10% of the undisclosed income of the said previous years). Further, if the conditions prescribed in 271 AAA (2) are complied with; no penalty would be leviable.

The conditions to be complied with are "If the assessee

i) in the course of the search, in a statement under S. 132 (4), admits the undisclosed income and specifies the manner in which such income has been derived

ii) substantiates the manner in which the undisclosed income was derived and

iii) pays the tax together with interest if any in respect of the undisclosed income

In order to have benefit of non-imposition of penalty, the assessee would have to admit the non-disclosure of income, and specify the manner it was derived. Further, he will also have to substantiate how the income was derived. This requirement was not prescribed in the presently applicable provisions. The assessee in order to get this benefit will have to pay the tax along with the interest due (as against the earlier requirement of having to pay only the tax amount).

The comparative position in regard to this penalty may be tabulated as under for a quick overview of the position pre and post amendment provisions.

Assessment Year	Applicable Provision	Penalty Leviable
For which Return furnished before initiation of search	271 (1) (c) – basic provisions	100% to 300% of tax sought to be evaded
For which return not furnished Due date expired	271 (1) (c) Explanation 5A	
For which return not furnished Due date not expired	271AAA	10% of the undisclosed income. No penalty if disclosure made U/s. 132 (4), manner of earning disclosed and tax paid
Relevant to the financial year in which search took place	271AAA	

Another change effected is that now apart from money, bullion articles found in the course of search, the concept of undisclosed income will now statutorily include entries in books, documents etc found in the course of search.

The assessee in order to get this benefit will have to pay the tax along with the interest due (as against the earlier requirement of having to pay only the tax amount).

A small but welcome change has also been effected in Explanation to S.271 whereby in computing the penalty u/s 271(1){c} 'the amount of tax sought to be evaded' which forms the basis of the amount of penalty; credit for TDS & Advance Tax paid before issuance of notice u/s 148 shall be given. Thus a statutory recognition is given to an eqitable basis of computation.

Thus the 'rationalisations' in the three areas covered above result in a mixed bag of improvements, opportunities and threats. The assessees and tax professionals will have to adapt to the same in a positive and proactive manner at the earliest.❐