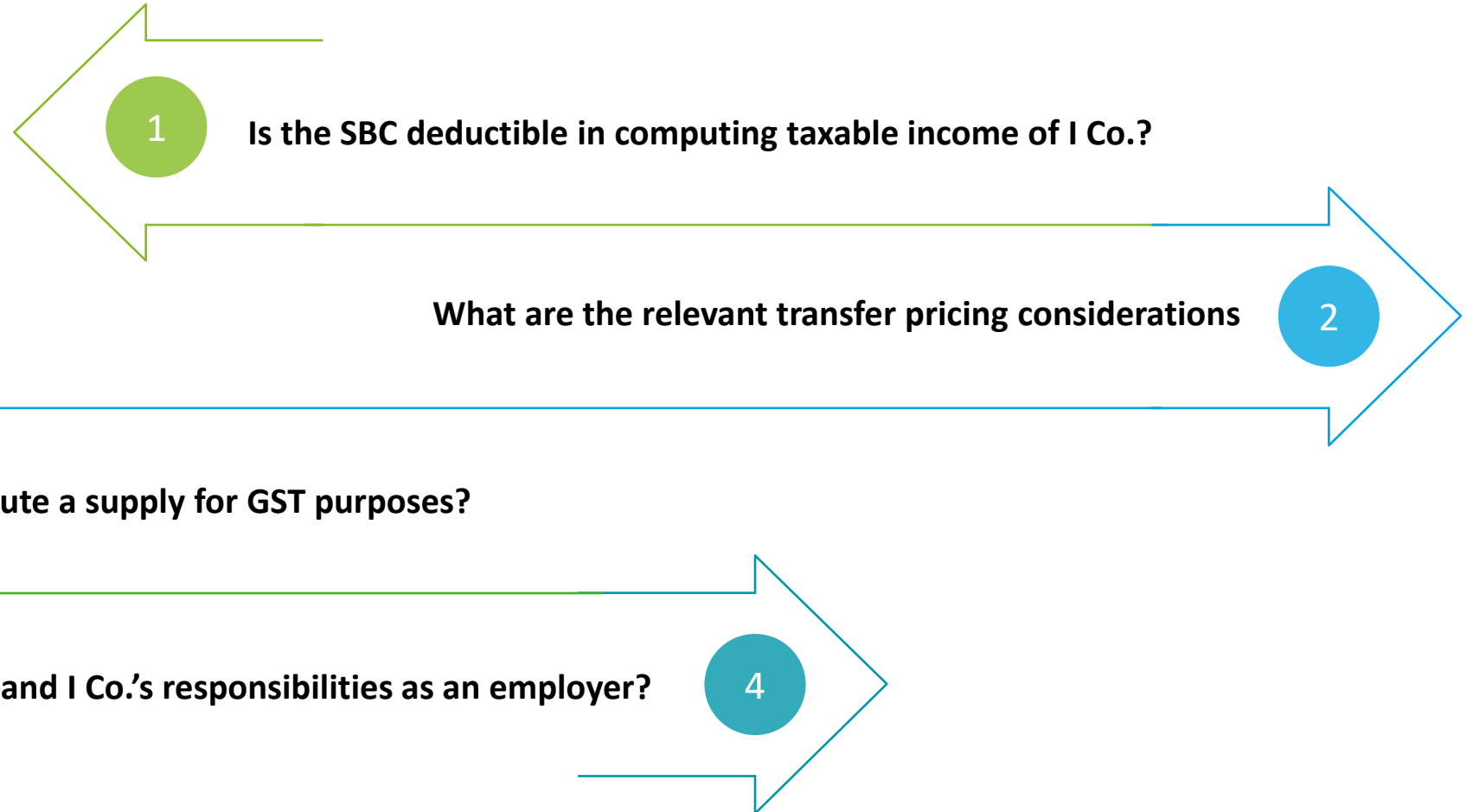


ESOPs and FoC  
transactions  
An insight into various tax  
implications

## Discussions/ considerations



## Polling question 1 - SBCs

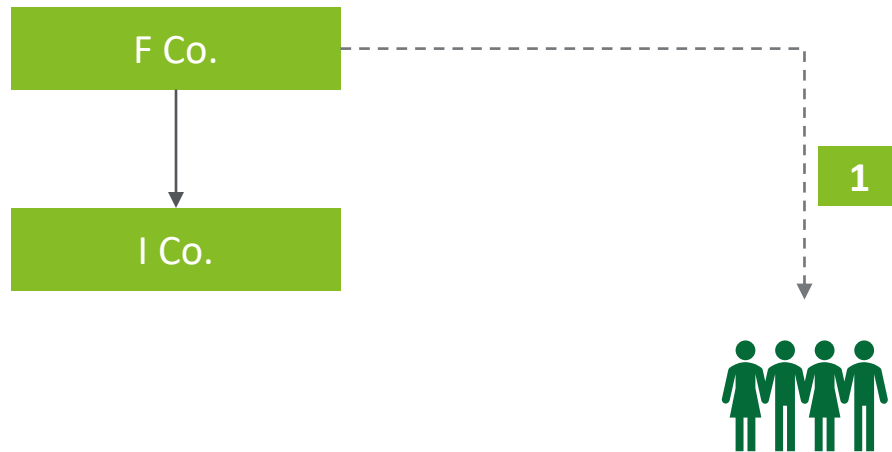


**With the increasing scrutiny on ESOPs, according to you, which area of the tax functions would be most impacted?**

- a. Corporate tax
- b. Transfer pricing
- c. Indirect tax – GST
- d. Personal tax

# Modes of granting Stock Based Compensation (SBC)

## Issue of shares of F Co. (Not cross charged to I Co.)



- **Step 1:** The SBC is provided to the employees in the form of shares of the parent entity at a discounted price
- The cost is absorbed by F Co.
- I Co. records the expense on account of SBC based on IGAAP/ IndAS (however does not have an outgo of funds/ resources)

## Issue of shares of F Co. (Cross charged to I Co.)



- **Step 1:** The SBC is provided to the employees in the form of shares of the parent entity at a discounted price
- The cost is initially absorbed by F Co.
- **Step 2:** The cost above, to the extent it pertains to employees of I Co. is cross charged by F Co. to I Co. and a payment is made by I Co. to F Co.

# Illustration



**1 April 2024**  
**1000 shares granted**  
**Nil Exercise price.**  
**Fair Value of INR 100**

**31 March 2025**  
**250 shares**  
**vested**

**31 March 2026**  
**250 shares**  
**vested**

**31 March 2027**  
**250 shares**  
**vested**

**31 March 2028**  
**250 shares**  
**vested**

## Statement of expense recognised by I Co.

Particulars	Year 1 FY 2024-25	Year 2 FY 2025-26	Year 3 FY 2026-27	Year 4 FY 2027-28
250 shares – vested 31 March 2025	25,000	-	-	-
250 shares – vested 31 March 2026	12,500	12,500	-	-
250 shares – vested 31 March 2027	8,333	8,333	8,334	-
250 shares – vested 31 March 2028	6,250	6,250	6,250	6,250
<b>Total</b>	<b>52,083</b>	<b>27,083</b>	<b>14,584</b>	<b>6,250</b>

## Cross-charged by F Co.

Particulars	Amount (INR)
Year 1	25,000
Year 2	25,000
Year 3	25,000
Year 4	25,000
<b>Total</b>	<b>1,00,000</b>

# Deductibility and TP considerations

## Scenario 1 - F Co. does not cross – charge expenses incurred by it to I Co.

- Considering the absence of defrayal of expenditure on the part of I Co., such expenditure is not allowable in the hands of I Co. although the same may have been accounted in the books of I Co. pursuant to applicable GAAP
- **From TP perspective**, such expense may be treated as notional expense particularly for a cost-plus entity. Thus, it is advisable to consider the filling of form 3CEB compliances.

## Scenario 2 - F Co. cross – charges expenses incurred by it to I Co. in accordance with the expenses recorded by I Co. in its books

- Considering that F Co. in this case raises a debit note, a payment is required to be made by I Co. which would cause funds to be paid irretrievably – constitutes an expense
- Such expense is to secure the dedicated efforts of the employees and to incentivize them – accordingly related to the business
- Represents expense that is deductible – Novo Nordisk ruling
- Subject to availability of a debit note and underlying calculations being backed by F Co.
- Non-applicability of withholding to the cross-charge where absence of an income element can be demonstrated
- **From TP perspective**, the deduction of ESOP cost reimbursed to the parent company in the year of payment is allowed and thus, treated as operating in nature for the computation of mark-up, if any.

## Scenario 3 - F Co. cross – charges expenses incurred by it to I Co. on a straight-line basis

- Considerations in relation to deductibility would be the same as Scenario 2
- One additional consideration is the quantum of deductibility – whether the amounts recorded by I Co. in its P&L or the amount of cross-charge received
- Better view is to claim an allowance in accordance with the debit note
- **From TP perspective**, a better view is to consider cost on basis of the recharge invoice (debit note) raised by F Co. under the recharge agreement between F Co and I Co. and the same would be treated as operating in nature for the computation of mark-up, if any.

# Recent trends and key considerations for deductibility

## Recent trends

- The issue has been historically settled in favor of the taxpayers – Biocon ruling of the Bangalore ITAT (upheld by the Karnataka HC]
- The tax authorities have filed a Special Leave Petition against the ruling of the Karnataka HC and a notice has been issued by the Supreme Court to hear the matter – pending adjudication and conclusion
- Tax authorities at the lower levels have been recently disallowing ESOP expenditure referring to them as capital expenditure (arising on account of short receipt of money against issue of shares]
- Additionally, in certain cases, the revenue is also terming ESOP expenses as capital expenditure related to issue of own shares thereby not allowing a deduction
- Courts and Tribunals have been allowing the deductibility to the taxpayers and following the Biocon ruling despite the pending SLP above
- As per UN Manual on TP (for country practice in India), ESOP expenses should be included in the cost base for the limited purpose of computing the mark-up,

## Key considerations for deductibility

- Documented ESOP plan spelling out the units granted, vesting conditions and exercise price, if any
- Grant letter issued to employees
- Calculations of ESOP discounts and graded vesting expense calculations
- Valuation report as on the date of grant and exercise
- Debit note issued by the parent company where shares of the parent company have been issued to the employees

# GST applicability on employee share-based payments

## Allegations by tax authority

### Premise

- Employees of the Indian company receive shares of the Foreign Company as stock based compensation at a discounted price.
- The cost to the extent it pertains to employees of Indian Company is cross charged by Foreign Company
- A payment is made by Indian Company to Foreign Company

### Transaction in money

- Indian Companies are arguing that the arrangement is transaction in money / securities and hence outside the GST ambit.
- Tax authorities allege that service received by Indian company merely cannot be a transaction in money as the Foreign Company is an independent entity located in non-taxable territory and is independent of the employer-employee relationship of the Indian company.

### Financial Service provided by Foreign Company to Indian Company

- Tax authorities are alleging that Foreign Company is providing a financial service to Indian Company.
- Thus, there is an import of financial service in the hands of Indian company to keep up their obligation and hence liable to tax under reverse charge mechanism.

### Employer-Employee relationship

- Indian Company adopted a position that services are in the nature of salary compensation provided under employee-employer relationship in terms of contractual agreement.
- **Press release by CBIC dated July 10, 2017**, which specifically comments on perquisites in the course of or in relation to employment affirms a no GST position
- Hence, will not be subjected to GST as per Schedule III of CGST Act



## Polling question 2 - SBCs



**Do you think the overseas company is acting as a service provider by providing SBCs to the employees of the Indian company. Should that be liable to GST?**

- a. Yes
- b. No

# What is the taxability for employees and I Co.'s responsibilities as an employer

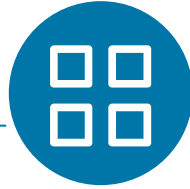
## Requirements and challenges

- The stock-based compensation is provided to the employees it is imperative that the benefit is recorded accurately and timely in the 24Q and consequently in the employee's Form 16 and form 12BA
- Reporting by Employer
  - In case of stock issued by the Overseas parent to Indian employees, the tax withholding and reporting obligation lies with the Indian employer. As the overseas company is not listed in India a Merchant Banker Valuation is necessary.
  - Similar provisions apply for stock issued by Indian employers. , the tax withholding and reporting obligation lies with the employer. While for listed companies the FMV would be the price quoted in the stock exchange as per Rules, for unlisted companies a Merchant Banker Valuation is necessary.
  - In either case the FMV used should be shared with the employees for capital gains calculations
- Challenges
  - Lack of visibility to the Indian payroll/ HR team where overseas stocks are provided only to a chosen few
  - Delay in receipt of information from the overseas teams resulting in delayed reporting
  - Reconciliation of the amounts reported as employee costs with the amounts cross charged
- Reporting by Employee
  - Perquisite as per form 16 needs to be reported as salary income in SI schedule
  - Stocks received through employer compensation plans need to be reported as 'Foreign Assets' in the tax return
  - Non-reporting of 'Foreign stock' attracts a penalty of INR 10 lakhs

# Implications of Free of cost transactions

# Impact of GST/ DT/ TP on “free of cost” (FOC) transactions

## Type of transactions



### Brand, logo, trademark, fixed assets and/or other intellectual property

- IP typically used by the companies located in India for the limited purpose for provision of services to the overseas group companies
- Fixed assets / goods received by the Indian entity from its overseas related party



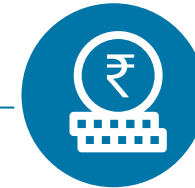
### Financial transactions

- Loans granted by group companies without any notional fees/ charges



### Technology (Software or IT) services

- Software licenses held by overseas entity and used in India
- Software or IT services provided to Indian company for providing services back to overseas entities or to Indian customers



### Support services

- Activities performed by overseas entity in the nature of day-to-day functions of the subsidiary/ Shareholder activities/ Intra-group services performed by overseas related party
- Legal services, tax service, cash flow management, accounting, auditing and budgetary control, etc.

# Impact of Corporate tax on free of cost transactions

## Free of cost services/ consumables

- Under this category, certain free of cost services are provided by the overseas group entities to the Indian entities
- For instance, certain free of cost software/ applications made available for the use of the Indian group. Certain IT supplies made available for the use of the Indian group free of cost
- These may not be recorded as expense of the Indian Company in the absence of defrayal of expenses by the Indian Company
- In case of cost-plus companies, tax officers seek to consider the value of these supplies in the cost base for markup computation
- In addition, they seek to tax the value of these supplies as consideration/ perquisite under Section 28(iv)

## Free of cost capital equipment

- Under this category, capital equipment is provided by overseas group entities to the Indian entities
- Most popular with Indian development centers who are provided hardware by the parent customer to test efficacy of software on the hardware provided
- These are not normally recorded as capital assets of the Indian entity under IGAAP
- However, in case of Ind-AS companies, these are recorded as assets by way of a notional entry and notional depreciation is charged therein
- Notional depreciation is sought to be imputed by tax officers and a corresponding markup is sought to be taxed
- In addition, the value of these equipment is sought to be brought to tax under Section 28(iv)
- Refer to illustration on the next slide

# Illustration on free of cost capital equipment

## Illustration facts

Particulars	Data
Profit before tax	INR 10 Mn
Value of free of cost capital equipment received for the FY (including assets received on loan amounting to INR 1 Mn)	INR 3 Mn
Depreciation on account of free of cost equipment as per books for the FY	INR 1 Mn
Markup rate	10%

## Tax computation sought to be adopted by officers

Particulars	Amount (INR)
Profit before tax	INR 10 Mn
<b>Add:</b> Book depreciation on free of cost equipment (notional)	INR 1 Mn
<b>Add:</b> Imputed TP markup on depreciation above	INR 0.1 Mn [INR 1 Mn x 10%]
<b>Add:</b> Value of free of cost equipment under Section 28(iv)	INR 3 Mn
Taxable income	INR 14.1 Mn

**The approach above leads to a double whammy – from a TP and Corporate tax standpoint**

# Is the action of the revenue authorities tenable?

## Free of cost services/ consumables

- From a transfer pricing perspective, imputation of value of services/ consumables is being included in cost base for markup computation
- This is also finding support in the form of discussions of revenue authorities in the course of APAs
- From a corporate tax perspective, where services/ consumables are intended to be provided in lieu of consideration, the same may be taxable under Section 28(iv) relying on the case of Priyanka Chopra
- However, services or consumables ***received for specific purposes may not fall under the ambit*** of the Priyanka Chopra case and may need to be differentiated

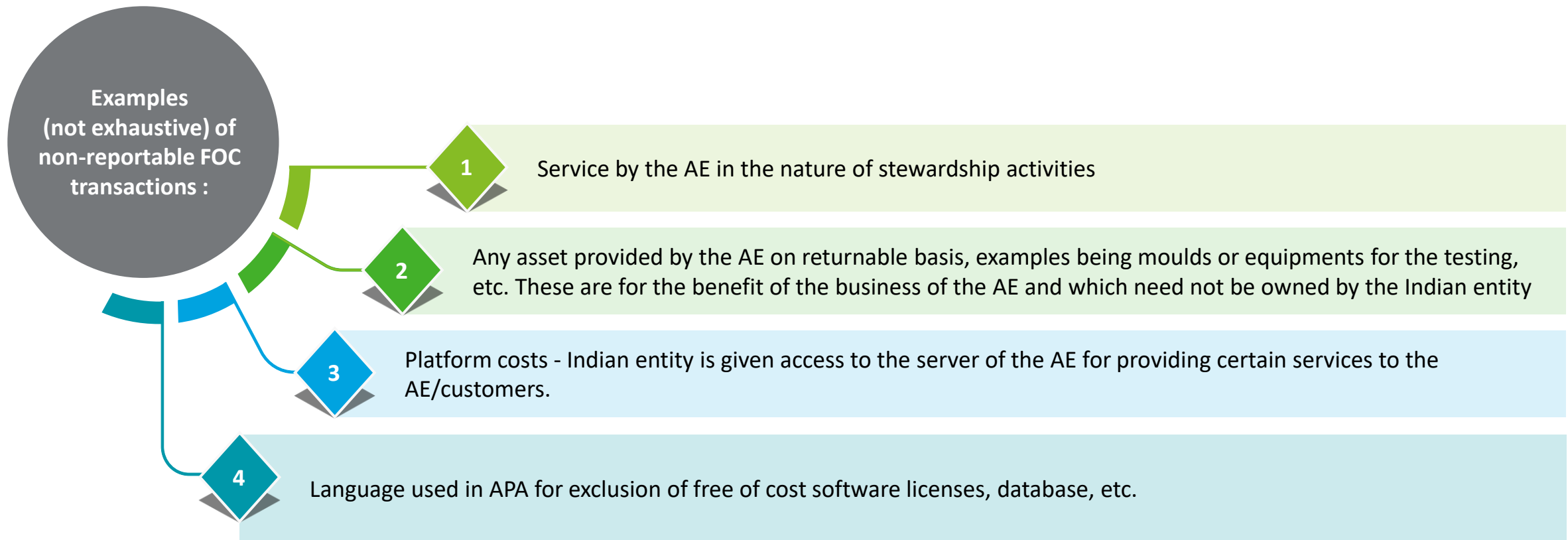
## Free of cost capital equipment

- The matter remains litigious considering recent inconsistent rulings of the Bangalore ITAT
- Marvell ruling – provides relief only to the extent of returned capital assets (loaned assets)
- HP ruling – taxes assets at values to the extent of benefit derived by taxpayers
- Sandisk ruling – relieves taxpayers from the 28(iv) adjustment in the presence of a transfer pricing adjustment
- One may need to track developments on this matter as it evolves and groups may wish to consider providing assets to Indian development centers on a paid basis
- Migrating to a model of outright purchase may pose logistical issues in (i) valuation of the assets and (ii) return of assets to the parent company by STPI units post completion of certain processes from a development standpoint – may be considered as export of goods by STPI units - may not be allowed

# Impact of TP on “free of cost” (FOC) transactions

## Reporting of FOC transactions

Not all free of cost goods and services can be regarded as reportable transactions. Only those transactions that benefits the Indian entity in its business operations, for which cost is not charged to Indian entity, may be covered under FOC transactions.



Thus, it is imperative that the one should first **identify** the reportable FOC goods and services transactions.



# Impact of TP on FOC transactions

## Key TP considerations



### ICAI guidance

- As per the ICAI guidance note, international transaction between associated enterprises and the Indian taxpayer, involving supply of FOC assets / services / tools need to be included in Form 3CEB along with a suitable note to explain their nature.



### India APA experience

- Based on our experience in the recently concluded unilateral APAs for Indian captive service providers, the APA authorities have been typically including notional cost pertaining to supply of FOC software/assets /tools in the cost base for the purpose of computing arm's length mark-up.

### India TP audit experience



- Some field level officers are scrutinising any supply of assets/tools/services on a FOC basis by overseas related party to the Indian captive service provider, operating on a cost-plus basis.
- The typical questioning includes:
  - Whether costs of such supply has been charged partly or fully by the overseas related party to the Indian captive service provider
  - Whether such costs have been included by the Indian captive service provider in the cost base for the purpose of charging a mark-up
    - If not included, then reasons for non inclusion
    - If included, the basis of quantification of the amount included in the cost base
  - The above questioning inter alia pertains to employee stock option plan, connectivity charges, management fee / intra group services and IT services/assets.

# Impact of TP on FOC transactions

## FOC Assets and Services - Reference to ICAI guidance note

The Institute of Chartered Accountants of India has issued a guidance note relating to the disclosures required under Section 92E. An extract of the relevant paragraphs is as under:

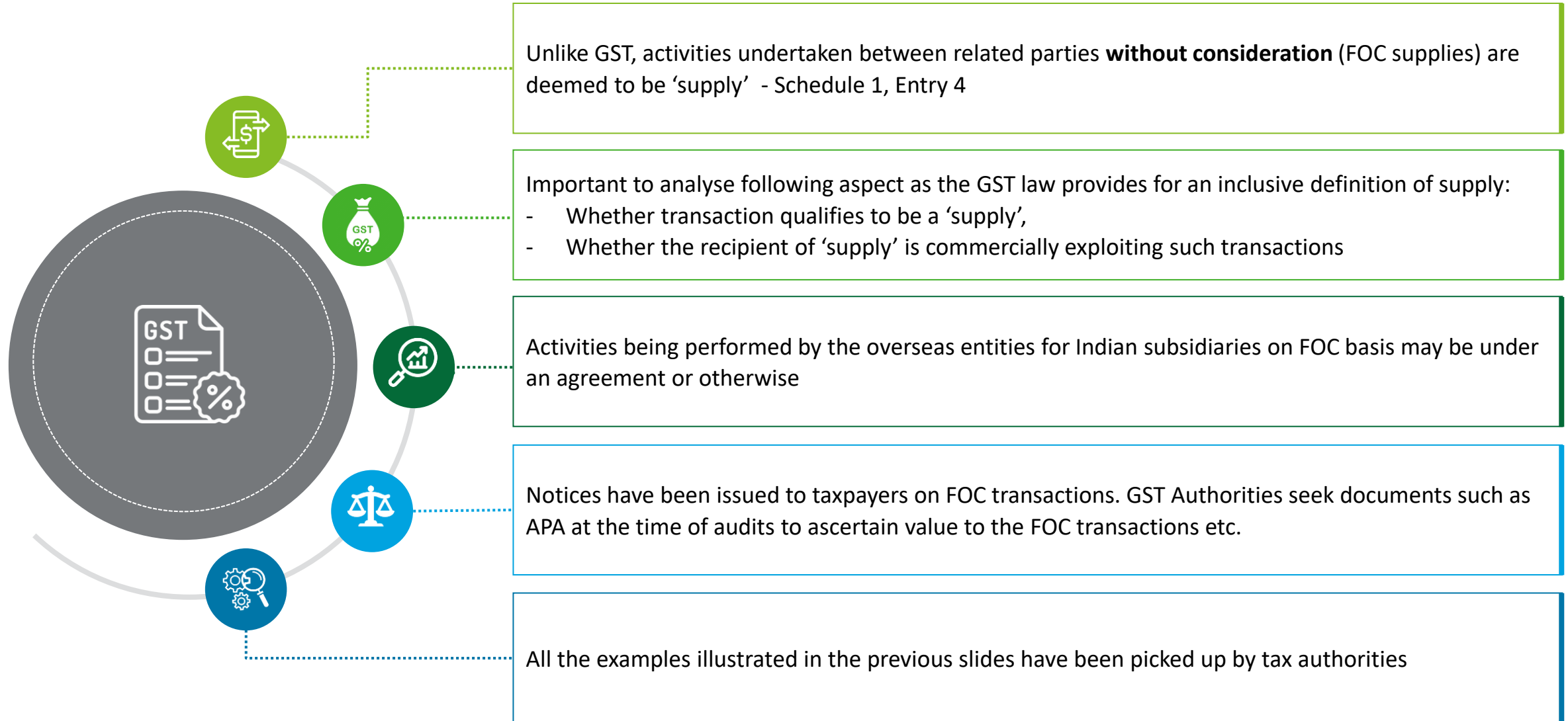
“4.17 When determining whether or not international transaction exist in the books of accounts or records of the Assessee, the Accountant also need to consider the free of cost goods / services rendered / availed by the Assessee. A reference can also be placed on the **positions adopted by the taxpayer under for GST** for such free of cost goods / services by the Assessee.

4.18 The Accountant will need to carefully examine the necessary facts/ conditions to assess and identify such transactions not otherwise apparent from books of accounts or records of the Assessee and make appropriate reporting for the same. **Where amounts are recognised on a notional basis in the books of accounts due to applicable accounting standards or otherwise, the same should be in conformity with arm’s length principle. Examples of such transactions may include free of cost employee stock option plans, free of cost software / software related services, free of cost management services, etc.”**

“9.55 Under this clause, the Assessee is required to furnish details of any other transaction having a bearing on profits, losses, income or assets i.e. it is a residual clause to cover any transaction which has not been covered in the preceding categories. **Examples of these transactions could be reimbursement transactions or transactions which do not involve any charge (i.e., free of cost services or goods). These transactions should be identified, and further notes could be provided to explain their nature.”**

# Impact of GST on “free of cost” (FOC) transactions

## Current tax environment



## Polling question 3 - FOC



**Have the income tax/GST authorities made additions in respect of FOC transactions for your companies?**

- a. Yes – Income tax
- b. Yes – GST
- c. Yes – Both
- d. No additions made

**Thank you!**

Kindly spare a minute to help us with your feedback for today's session...

For any queries, please feel free to write to us at [intax@deloitte.com](mailto:intax@deloitte.com)

# Annexure

## **CGST Act**

Section (52): “goods means every kind of movable property **other than money and securities** but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply;”

Section (102) “services means anything **other than goods, money and securities** but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged;

Schedule 1, Entry 4 “import of services by a person from a related person or from any of his other establishments outside India when made in the course or furtherance of business”

## **SEBI**

“(h) “securities” include— (i) **shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities** of a like nature in or of any incorporated company or other body corporate; 9 (ia) derivative; (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes; (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; (id) units or any other such instrument issued to the investors under any mutual fund scheme; 12(ii) Government securities; (iia) such other instruments as may be declared by the Central Government to be securities; and (iii) rights or interest in securities;”



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