Post-Budget Memorandum

Submitted by the Internet and Mobile Association of India

1. The case for withdrawal of FBT on ESOPs for internet/mobile value added services companies

Background

The Finance Bill, 2007 has proposed to levy Fringe Benefits Tax (FBT) @ 33.99% on the benefit granted to employees on exercise of ESOP. For this purpose, clauses 30 and 31 have been inserted which seek to amend section 115WB and 115WC respectively of the Income Tax Act, 1961.

In terms of the proposed amendment, the value of fringe benefit would be the fair market value of the specified security or sweat equity shares on the date of exercise of the option by the employee as reduced by the amount actually paid or recovered from the employee in respect of such security or shares.

The Finance Bill has also proposed to delete the proviso to section 17(2)(iii) which had provided that the benefit granted to an employee under ESOP would be exempt from taxation as perquisites if the ESOP was in accordance with the Central Government guidelines.

Typical Effect

The internet economy in India is a fledgling one as compared to other large economies. This industry is poised to rapidly transform the lives of millions of Indians by bringing the power of knowledge and information to the masses. At the heart of this economy is a limited core of highly motivated and skilled employees and first generation tech entrepreneurs who are working on cutting edge technologies and striving relentlessly to catapult the Indian online industry to its rightful place on the global internet map. Indeed a number have already attained international fame and recognition.

Many of these companies are relatively small start ups working on limited financial resources and lack the size and financial muscle of players in other mature sectors. However they do need to attract and retain some of the sharpest minds in this country and even from overseas [much of the reverse brain drain in India has happened in this sector]. Such businesses have been relying heavily on stock options to attract and retain talent. A number of these businesses, which are not yet generating significant profits are today judged to be very valuable by external markets (perhaps disproportionately so when compared to almost all other industries).

To take an example, **Rediff.com India Limited**, a member of our association, which has over the past ten years grown to be a leading global internet player has started generating profits only from last year. Net profit for the year ended 31st March 2006 was Rs. 5.50 crores. The stock markets however value this company in excess of Rs. 2000 crores. Consequently even if 1% of the company's shares were exercised the resultant **Fringe Benefit Tax would have not just wiped out the entire profits for last year but would have plunged the company into deep losses.** This would cause great consternation among the investing community upon whom this industry is heavily dependant.

In the interest of growth of the internet industry we would urge you to withdraw this proposed levy on internet companies. Arguments in support of our request include the following:

1. In view of the high value of technology and intellectual property developed by companies in this space the "fair market value" of internet businesses is usually disproportionately high as compared to profits. To tax such companies on the market value of shares rather than on business profits would be putting an undue burden on them.
2. It will be impossible to predict in advance the timing and quantum of FBT and hence the fortunes of a company will swing wildly from period to period merely on account of timing and quantum of exercise. The investing community, on whom this industry is heavily dependant, does not like such surprises.
3. It is the employee and not the company who benefits from such sale and it is therefore logical that the employee should bear the tax on such gain, as is currently the case.
4. Typically employees who leave an organization carry their vested options with them. Levy of FBT on exercise would thus require companies to bear this burden not just for employees but ex-employees as well.

Recommendations:

The following are, therefore, suggested for consideration:

1. **The proposed amendment should be dropped and the ESOP benefit should only be charged to tax in the hands of the employee**
2. **If the proposed amendment is not withdrawn it would give an unfair advantage to "foreign" companies who will be able to attract employees with foreign ESOPs which are not taxed in the manner the bill is proposing to tax Indian companies.**

2. Amendment to Section 10(23FB) of Income Tax Act proposed in the Union Budget

Background

Section 10(23FB) of the Income-tax Act, 1961 (IT Act) provides that any income of a Venture Capital Fund ('VCF') or a Venture Capital Company ('VCC') is exempt from tax. However, the Finance Bill, 2007 has proposed an amendment to Section 10(23FB) which restricts the benefit only with respect to income from investments in Venture Capital Undertaking ('VCU'). Further, the definition of VCU is proposed to be amended to cover companies not listed on a recognized stock exchange in India and engaged in the business of

Nanotechnology, **Information technology relating to hardware and software development**, Seed research and development, Bio-technology, Research and development of new chemical entities in the pharmaceutical sector, Production of bio-fuels, building and operating composite hotel-cum-convention centre with seating capacity of more than 3,000, and Dairy or poultry industry.

Thus with the amendment taking effective, investment by a VCF and VCC in companies other than those mentioned above would not be eligible for claiming the benefit under the said section.

Recommendations:

The following are, therefore, suggested for consideration:

1. **This measure, while not garnering much revenue, would adversely impact the fledgling Indian Venture Funds while the others will by pass its impact. This would not be healthy for creating ecology of venture funds in India.**
2. **Restricting venture fund flows to specific areas by law is counterproductive and restrictive to very nature of such funds and the issue should be left to be decided between entrepreneurs and investors**
3. **It is our understanding that the definition information technology including software and hardware would include internet and mobile content companies. However, since a most of the tech innovation and tech entrepreneurship in India is happening in these two segments, and since these two sectors are significantly dependent on Venture Capital at various stages in their growth, the government may consider formally including these two segments as a part of information technology to bring more clarity to investors.**