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Abstract
As taxation policy seeks to recognise substance over form, it is important to view ESOPs as a whole at the international level, in the same way as they are generally given special treatment at the national level. The problem will become more acute as the labour market becomes more mobile. Increasingly, ESOPs are used to reward senior executives. As long as they fall within the favourable or particular treatment given to ESOPs in most jurisdictions, there is scope for significant double or non-taxation.

Keywords
employee, stock options, India, tax policy

TAXATION OF EMPLOYEE STOCK OPTION PLANS: INTERNATIONAL PRINCIPLES

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As taxation policy seeks to recognise substance over form, it is important to view ESOPs as a whole at the international level, in the same way as they are generally given special treatment at the national level. The problem will become more acute as the labour market becomes more mobile. Increasingly, ESOPs are used to reward senior executives. As long as they fall within the favourable or particular treatment given to ESOPs in most jurisdictions, there is scope for significant double or non-taxation.

Introduction

In the normal course of commercial contracts or dealings on revenue account, payment for the benefit received is made simultaneously or within a small period of credit. Thus, payment by the recipient of the benefit closely follows the fulfilment of the obligations by both the parties to the contract. This normally also applies to an employer-employee relationship.[1] Salary is paid to an employee for services rendered, within a specific time, after the expiry of the defined period. In India for example, this is a calendar month.

Over time, for various purposes and reasons, the form and timing of payment of components/elements of salary has changed and is often deferred. A bonus may be paid to an employee after the end of the accounting year, and in many situations, after ascertaining the profit earned by the enterprise. Further portions of salary may be deferred to provide for employee retirement. Deductions from salary are contributed and accumulated under such schemes. Employers often make matching contributions.[2] The total contributions earn income from investments for the benefit of the employee. This is the basis for many social security schemes.

Employee Stock Option Plans and their variants (ESOPs) owe their origin to recognition of the concept that profits earned by an entity are in a large

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1 J Mossner, 'General Report' *Cahiers De Droit Fiscal International* (2000).

2 In some countries, such as Australia, this is required.

measure due to the labour of the employees. It is then appropriate if such profits are, at least in part, given back to the employees. Giving employees shares, or an option entitling them to acquire shares, achieves this. The employees can then be regarded as beneficial owners of the company and thus indirectly entitled to participate in the wealth created by their efforts.

In this way, the profits are not distributed to the employees immediately, but are retained in the company on the assumption that the employer will be able to grow the profits faster than if they were disbursed to the employee. There is a further assumption that employees will realise that they are the owners, at least in part, of the company, and this should reinforce their commitment to the growth of the company, and thereby their own wealth creation.[3] ESOPs have thus become a very potent mechanism, the world over, for hiring, retaining and rewarding a talented workforce.[4]

ESOPs by their nature are schemes of deferring salary to an employee. The period of deferral would vary, depending upon the philosophy of the employer or the 'carrot and stick policy'. ESOPs have also been structured to achieve other objectives.[5] Thus, an ESOP mechanism could be used for 'signing-up' an employee. It could be used for remunerating technical and qualitative contributions by key personnel ('sweat equity'). ESOPs could be used for altering control over a company within a family. They can also be used for remunerating employees but purely for cash-flow purposes.

Various types of arrangements have evolved to allow employees to become shareholders in recognition of services rendered to the company. The arrangements have different names, but are in substance the same. Various means of financing employees to acquire their shares have evolved simultaneously.

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3 This was reflected in Australia in the Report by the House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours: Inquiry into employee share ownership in Australian enterprises* (2000)(ESO Report), available at <http://www.aph.gov.au/house/committee/eewr/eso> (at 25 January 2003). At vii, the ESO Report states that one of the main government policy objectives in encouraging employee share ownership was, 'to align more closely the interests of employers and employees so that share holding employees appreciate more directly the impact of management and work practices on efficiency, productivity and profitability'.

4 JR Varma, *Committee Report on the Employee Stock Option Schemes* (1999) (Varma Report). The committee was constituted by the Securities & Exchange Board of India.

5 See the general discussion in D Williams and DP Tuch, *Taxation of Employee Share Schemes* (1999). See also for Australia, the ESO Report, above n 3 and for India, the Varma Report, ibid.

The methods used in India are representative of international practice and include:[6]

(i) 'Employee stock option plans', where the employee allows the employer to withhold a portion of her or his monthly salary, to acquire shares of the employer company at a discount. Such acquisition of shares may happen each month. Alternatively, the portion of salary withheld may be accumulated to enable the acquisition of shares at a future date.

(ii) 'Employee stock ownership plans' where an employee of the company is given a choice to acquire shares of the company at a pre-determined price after a certain period. These shares may be acquired/allotted from the company directly or indirectly through a trust.

(iii) 'Employee stock purchase schemes' where the company offers shares to an employee as part of a public issue or otherwise at a pre-determined price.

(iv) 'Employee stock option schemes' where a company grants options to its employees to buy a specified number of shares at a specified price during a specific period.

(v) 'Stock appreciation rights or plans' where the employees are awarded stock equivalents at a certain pre-determined value and after a certain minimum stipulated period, the employees are allowed to encash such rights.

Some of the variations to these broad categories include:

(i) An option may confer a right to buy existing shares rather than newly issued shares.

(ii) The option may confer a right to acquire shares of either the holding company or the subsidiary company or a trust holding shares of such companies.

(iii) A trust, with finance provided or arranged by the employer company, may acquire the shares, which are then allotted to the employees.

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6 ESOP Guidelines issued by the Central Government of India under s 17(2) of the *Income Tax Act 1961*, 251 *Income Tax Reports* (ITR)(Statutes) 230. For further examples, see the comparative survey of 'Tax Treatment of Employee Stock Options' 3(6) (2001) *IBFD Derivatives and Financial Instuments* 290, D Bentley, 'Australia' 290, J Muyldermans and C Moeskops, 'Belgium' 300, and C Hagen, 'Germany' 310. For an extended analysis of methods used in Australia, see the ESO Report, above n 3.

The employee's method of raising finance to participate in these schemes would depend upon the type of scheme promulgated by the employer. The objective for any employee would be to maximise the benefits with the least financing cost. In India, for example, the provisions of the *Companies Act 1956*, permit an employer to advance money to an employee to enable the latter to acquire shares in the company.[7]

The tax implications attached to any scheme should be founded on the same principle: the employee should be taxed at the time 'salary' is received. However, international practice is not uniform. Tax liability may therefore arise at varying points of time, depending on the jurisdiction.[8]

Salary is almost uniformly taxable on a receipts or accruals basis. Salary is taxed on a receipts basis at the time when it is paid. It is taxed on an accruals basis when a right to receive the salary is established. It is at this point in time that the employee is said to have acquired a vested right with no substantial risk of forfeiture.[9]

Receipts or accruals bases of taxation are mutually exclusive. Both tests would therefore have to be applied to find out the taxability of the benefit received by an employee under an ESOP. The peculiarity of an ESOP is that the taxation of a benefit received is normally in a different year from the year when the services were rendered.

There are various stages in the implementation of an ESOP, which can be broadly categorised as:

a) Grant of options;
b) Vesting of options;
c) Exercise of options; and
d) Sale of the shares received on exercise of the options.

Although these are the normal stages in an ESOP plan, experience has shown that companies have developed many variants to this. Thus, for example, a

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7 Compare the Australian position, where such loans, if offered at low or no interest, would usually attract fringe benefits tax in the hands of the employer.

8 For useful comparisons of different rules see Williams and Tuch, above n 5 and IBFD, above n 6. The Australian position is set out in that comparison in Bentley, above n 6. For an exhaustive treatment of the Australian rules, see M Chamberlain, 'Tax treatment of employee options: what are the issues?' a presentation for the Taxation Institute of Australia, 27 September 2001 and F Cooper, 'Employee share schemes', a presentation for the Taxation Institute of Australia, 13 August 1999. Both are available at <http://www.tia.org.au> (as at 25 January 2003).

9 As stated, for eg, in US Inland Revenue IR 36 (17 March 1998).

company may incorporate a lock-in-period even after the exercise of the options.[10] Further, the vesting schedule of an option may not be uniform in all schemes. Options may, for example, vest uniformly over the eligible period or, in the alternative, they may vest in unequal proportions.

Salary is normally defined to include any benefit or amenity granted to an employee free of cost or at a concessional rate.[11] The question that needs to be addressed in relation to an ESOP is at what stage the employee is said to have acquired such a benefit or an amenity? Is it at the stage of the grant of the options? Or is it at the stage of vesting the options? Or is it at the stage of the exercise of the options? Or is it at the stage of the sale of shares received on the exercise of the options?

Various arguments could be advanced as to why the benefit is taxable at any of the above stages only and not the other. Because of this, there is no uniform international practice as to the time of taxing the benefit received under a stock option plan. The variation in practices is also, in some measure, increased by governments' desire to tax the benefits at the earliest point of time. This article examines some of the legal issues involved in the taxation of the benefits of a stock option plan at its various stages.

Taxation of options at the time of grant

A grant is a process by which an employee is given an option. The document outlining the grant generally sets out the proposed contractual terms governing the delivery of the options to the employee, including such matters as the number of options given, the time of vesting and any special terms that might apply.

A grant is thus an offer from a company. The offer proposes to extend certain benefits to an employee. The employee has a right, without any obligation, to accept the offer on the stated terms. It is when the employee accepts the offer

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10 For example, in Australia, taxpayers can qualify for an election to include the discount on the issue of a share under a qualifying employee share scheme in their assessable income in the year they acquire the share. However, the election only applies if the scheme does not allow recipients, among other things, to dispose of the share within three years of acquiring the share. Section 139CE *Income Tax Assessment Act 1997* (Cth).

11 For example, s 17(2)(iii) of the *Income Tax Act 1961* in India states that:
Perquisite includes:
(iii) the value of the benefit or amenity granted or provided free of cost or at concessional rate in any of the following cases:
(a) by a company to an employee who is a director thereof
(b) by a company to an employee being a person who has a substantial interest in the company;…

that mutual obligations and covenants become enforceable. A grant of options thus gives an employee a possibility of securing some benefit in future.

Salary may be paid in cash or in kind. Salary may be paid in kind, for example, by the allotment of an asset. An asset would usually be defined to include property. For example, the Supreme Court in India has defined the term property to mean every conceivable right or interest that a man can hold and enjoy.[12] The term 'property' signifies 'things and also rights considered as having money value'.[13] If the grant is regarded as a right it is property and hence salary in kind. The taxation of a benefit under an ESOP at the grant date proceeds on the assumption that it bestows on an employee an economic advantage in the form of the intrinsic value of the option right.[14]

The taxation of a benefit under an ESOP at the grant date thus presumes that the employee is given property. When this property is ultimately realised, the gains would normally be regarded as capital gains. This would be despite the fact that the relationship with the employer may continue. Merely because the relationship with the employer continues, it would not be appropriate to regard every kind of profit made by an employee as being a part of salary. It is only when the gains have a real and direct nexus to the provision of services that a charge under the head 'Salaries' would arise.[15]

Options granted to an employee may be transferable or non-transferable. In the case of transferable options, the employee would have an immediate opportunity to turn to pecuniary benefit the inherent value of the options. Therefore, to tax the value of the benefit from the transferable options as income at the time of grant would appear theoretically appropriate and just. In the case of the transferable grant, if no strings are attached to the ownership, the valuation may also not give rise to much complication for tax purposes.[16] The options may not, however, be quoted on the stock exchange. To that extent, a figure depicting the value of the options may not be available. Nevertheless, taking into account the restrictions involved, together with any other limiting factors, it is theoretically possible to value such options.

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12 *Ahmed G H Ariff v CWT* 76 *Income Tax Reports* 471. In Australia, rights and options, although recognised as a form of intangible property, are dealt with under the capital gain and loss provisions in Part 3 of the *Income Tax Assessment Act 1997* (Cth).

13 AH Hudson, *Dictionary of Commercial Law* (1983).

14 Mossner, above n 1, 97.

15 Kanga and Palkivala, *The Law and Practice of Income Tax* (8th ed 1990).

16 This may be compared to valuation of the grant for accounting purposes in the hands of the company and the current debate as to whether options should be expensed at the time of the grant. Compare, for example, the decision by Coca Cola and other companies to take such action, announced in July 2002, and the ongoing debate within the International Accounting Standards Board as to the appropriate basis for that valuation.

Valuation of options may be difficult and may involve some subjectivity, but is not impossible. The benefit derived by an employee, being the difference between such value and the amount paid to the company, can be regarded as arising from employment and hence a part of salary.

Even non-transferable options can be given a value. Extending the logic applied to transferable options, it is arguable that a taxable event may arise at the time of the grant of non-transferable options. The intrinsic value of such options may be arrived at by mathematical model and the value of the benefit determined accordingly. The fact that the profits may not be realisable until a later date, or may be subject to a contingency, may reduce their present value, but that would be no reason for treating them as though they had no value until realised.

In the leading case for much of the Commonwealth, a majority of the House of Lords held in *Abbot v Philbin*,[17] that the taxable event would arise at the time of the grant of options. Viscount Simonds observed:

> My Lords, I cannot entertain any doubt that, when the company granted the option to the appellant, he acquired something of potential value. I do not think that it matters whether it falls into the category of proprietary or contractual right, or into some dim twilight that divides those juristic conceptions. We are concerned with a taxing statute whose language is to be reconciled with the law of England and Scotland alike, and the chosen words 'perquisite or profit whatsoever' are as wide and general as they well could be. I can concede no relevant limitation of their meaning except in the oft cited words of Lord Watson in *Tennant v Smith*[18] that they denote 'something acquired which the acquirer becomes possessed of and can dispose of to his advantage – in other words, money – or that which can be turned to pecuniary account'.

In October 1954 the taxpayer, who was at all material times secretary of a company, was granted an option to purchase 2,000 ordinary shares in the company at 68s 6d per share. The price of the option was £20 and it was expressed to be non-transferable and to expire after 10 years or on the earlier death or retirement of the taxpayer. In March 1956, when the market price of the shares was 82s per share, the taxpayer exercised the option on 250 shares. The taxpayer was assessed to income tax under Schedule E of the *Income Tax Act 1952* (UK)[19] in the year 1955-56 on the difference between the option price and the market price of the shares (with a deduction of a proportionate part of

17 [1961] AC 352.
18 [1892] AC 150, 159.
19 *Income Tax Act 1952*, Sch 9 r.I: 'Tax under schedule E shall be annually charged on every person having or exercising an office or employment of profit mentioned in Schedule E… in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom for the year of assessment…'.

the cost of the option), as being an emolument received by him by virtue of his employment. The taxpayer appealed on the ground that the assessment should have been made in the year 1954-55.

Holding that the grant of options itself was the conferment of an asset, Viscount Simonds went on to observe that an option to take up shares at a certain price is a potentially valuable right.[20] He said that employees are prepared to pay for such options because they can provide a pecuniary benefit.[21] To have potential value, they neither have to have been realised, nor valued, they must simply be capable of being turned into money.[22] The judge stated that:[23]

> It treats the option as a thing of no value until it has been exercised and places an importance, in my opinion unjustified, on the non-transferability of the option. But, as I have pointed out, though that feature may reduce the value of the option, it cannot alter its character so that it is no longer something which can of its nature be turned to pecuniary account. Nor, even if it be the fact, can I accept the view clearly entertained by the Court of Session that, if in the year of grant the option had no value, it therefore became a taxable perquisite when in later years it was exercised. It was, in my opinion, a perquisite at the date of grant and, if it had no value, there was nothing to tax and that is the end of the matter.

Economically, however, no advantage arises to an employee when non-transferable options are given.[24] In fact, the existence of an economic advantage is itself in doubt. This is because an option gives only a chance of an economic benefit. An exercise may not occur where the conditions of the ESOP are not fulfilled, the price is not favourable, or the options lapse. If, therefore, an employee were taxed at the time of grant, it would be a tax on a notional advantage. Hedging of an option or the underlying shares may not be permissible and/or possible. An employee may not be able to secure for her/himself a certainty of an economic advantage.

To put the whole thing differently, it is arguable that options confer only a future, uncertain, volatile and inchoate right. An employee should be taxed on what reaches her or his pocket.[25] If there is an uncertainty about the amount/asset reaching the employee, the taxable event should be deferred until

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20 Above n 17, 365.
21 Ibid.
22 Ibid 366.
23 Ibid 368.
24 See further, J Willoughby, 'Current and future share plans in Australia' presentation for the Taxation Institute of Australia, 27 September 2001 and available at <http://www.tia.org.au> (as at 25 January 2003).
25 *Pook v Owen* 45 ITR 571, 592 (HL).

the event arises. Taxation must be of real and not hypothetical or notional income.[26]

The right through a grant is clearly not a present right but is exercisable in the future. Further, the right is coupled with certain obligations in the form of conditions to be fulfilled before an incipient right is transformed into a substantive right to exercise the option.

An option, which represents a future right, will have to be valued in the present. Valuation, in the future, of a definite amount arising after a definite period, can be done by a simple procedure of discounting. However, in the case of an option, both the amount and the time may be uncertain. The amount is uncertain because the value of the share at the point of time when the employee is eligible to subscribe to them, or opts to subscribe to them, is uncertain and indeterminate. The point in time at which the employee is in a position to exercise this option to purchase a share may also be indeterminate, because certain conditions may require the employee to remain in the employment before exercising the option. An employee acquires the right to purchase the shares not merely because of holding the warrant, but also on account of fulfilling certain conditions relating to employment. If these conditions are not fulfilled by the time the employee resigns or is dismissed, the employee may not get the right. The right itself therefore remains an uncertain one. The value of the right contained in the option is therefore indeterminate. Ultimately, it may not result in any benefit to the employee.

Despite the fact that taxing the benefit received in an ESOP at the time of the grant of options appears theoretically justifiable, only a few countries are currently taxing the benefit at the time of grant of options. Australia is one.[27] However, taxpayers in "qualifying" employee share schemes in Australia may either defer the tax time or elect to include any discount on the grant of an option in their assessable income in the year of acquisition and receive a special exemption for the first A$1,000.[28] Other examples include Switzerland, Belgium and Sweden.[29]

26 *United Commercial Bank v CIT* (1999) 240 *Income Tax Reports* (ITR) 355 (SC).
27 ITAA36 s 139B requires a taxpayer acquiring a share or right under an employee share scheme to include the discount given in their assessable income for that income year.
28 ITAA36 ss 139B and 139BA.
29 Mossner, above n 1, 97.

Taxation at the time of vesting

'Vesting' is the process by which the employee receives the right to apply for and be issued shares of the company under the options granted. Until the vesting takes place, the employee does not have a right to apply for the shares. Upon vesting, the employee gets an unfettered right to apply for the issue of shares upon fulfilment of the conditions.

As already stated, the grant of an option may be accompanied by certain restrictive conditions. The removal of the conditions attached to an option may occur after its grant, but before its exercise. Normally this happens once the performance criteria have been fulfilled. Then the option may be declared fully vested and freely transferable. As discussed, subjecting an option to tax at the time of vesting may be considered theoretically sound.

Vesting is thus a situation wherein the lock-in conditions are released. This happens after the various obligations have been fulfilled. The liabilities and uncertainties to which the options were subject are removed, the requisite period has elapsed, and the employee is now in a position to exercise the option and deal with the shares. The employee has an unqualified right over the share. The share may also be freely disposable in the market.

This right is clearly related to the contract of employment. It is only through the employment and after fulfilling any conditions set by the employer that the employee becomes entitled to the option, which can then be converted into a share. The right to obtain a share is forfeited if the conditions of employment are not fulfilled. Therefore the right of an employee over the share is only a contingent right till the lock-in period is over. Once the lock-in period expires, and on fulfilment of all the conditions (which are essentially employment related conditions), the employee is released from a requirement to return the option and acquires full rights over the potential shares. The contingent right is converted into a vested. Only at this point deos an employee obtains a benefit from the employer of a potential share with a particular market value.

As each of the conditions imposed at the time of issue of option is fulfilled, the right of the employee becomes increasingly definite, and subject to fewer liabilities. But, it is only when the last of the conditions imposed has been met, that the right transforms from a contingent right into a crystallised right. At this point, the employer gives a benefit to the employee by way of release of the lock-in conditions of options issued at less than the market value. It is therefore only at this stage that the perquisite could be recognised. Mossner's report shows that the practice of taxing options at the time that they fully vest in the employee is not prevalent.[30]

30 Above n 1.

Taxation of an option at the time of exercise

'Exercise' of an option means that the employee applies to the company for the issue of shares against options that have vested under an ESOP. An option may be seen as the opportunity to secure a future benefit. If so, its exercise, where an employee receives shares, would be an event where the expectation of profits is crystallised in the form of an asset being transferred to an employee. The transaction would be akin to the sale of an asset to the employee. If the asset were sold below the fair market value, the benefit conveyed or transferred to an employee would be regarded as a perquisite and taxable.[31]

Another argument for taxing the benefit at the time of exercise is that the shares are given to an employee at a price below its potential price. To the extent that the employer forgoes the right to realise the full value of the shares, there would be a loss. Such loss is correspondingly a gain to an employee. The gain arises out of employment and should be taxed as part of salary.

The minority judgments in the of the House of Lords in *Abbot v Philbin*[32] favoured taxing the benefits at the time of exercise of the options. Lord Denning observed:[33]

> My Lords, I ask myself, what is the difference, for tax purposes, between the case I have just put, where nothing is paid for the option, and the case we have before us, where a nominal sum is paid? The difference is that in the one case he has only an expectation of profit: whereas in the other he has a right to make profits in the future, if the opportunity arises. But in either case, until the option is exercised, he has not the profits themselves. And as I read the Act it is not the expectation to make profits, nor the right to make profits, which is taxable, but only the profits themselves. Just as it is not the expectation to salary nor the right to salary which is taxable, but only the salary itself. A bird in the bush is not taxable, even if you have the right to get it in the future, if it is still there. You must have it in hand before you can be taxed for it.

An option merely sets-up the machinery for creating a benefit. The benefit accrues on its exercise. It is therefore appropriate that the taxable event arises on the accrual of the benefit. The employee, by exercising an option, secures an economic advantage. The expectancy of realising a benefit is crystallised and becomes a reality. As Lord Denning added in *Abbot v Philbin*:[34]

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31 *S Vardharajan v CIT* 89 Taxman 489 (Mad), India.
32 [1961] AC 352.
33 Ibid 384.
34 Ibid 385.

> My Lords, the point which I am now making can be tested by taking an illustration which is suggested by what Lord Atkin said in *Salmon v Weight*.[35] Suppose that a colliery company made an offer to supply a director, who was in the coal trade, with 1,000 tonnes of coal at a price which was one-third of the market price of the day. No profit of any kind would be made by the director until he gave an order for coal. But as and when he ordered the coal and got it, he would receive a profit in the nature of money's worth. It would be assessed, said Lord Atkin, at the difference between the price he could get for it, and the price he had actually paid. Now take the same illustration but suppose that, instead of the company making an offer to the director, a clause was inserted in his service agreement giving him the right of obtaining coal at a price which was one-third of the market price of the day. Surely his profit would be just the same as before. It would arise as and when he ordered the coal and got it: and it would be assessed at the difference between the price he could get for it and the price he actually paid. It would not be assessed differently simply because in the one case he made the profit as a result of a standing offer, and in the other he made it under a service agreement.

The decision of the House of Lords in *Abbot v Philbin* went against the claim of the Inland Revenue that the benefit from stock options is taxable at the time of exercise of the options. Because of the *Abbot v Philbin* case, the law in the United Kingdom was amended to charge any profit on the exercise of share options to income tax. This change was guided substantially by the administrative practicalities, in particular, the difficulty of determining the value of the options at the time of grant.[36]

It is theoretically possible (although not practically done) that an employee will exercise the options when the price of the share is below the option price. This would result in a loss to the employee. Most jurisdictions that tax options at the time of exercise would not give a deduction for such a loss.[37] This is one of the arguments against tax being levied on an employee at the time of exercise of options. It is theoretically discriminatory. A profit or gain on exercise of an option may be taxed as income, but a loss may not qualify as a deduction.

However, the argument is one of policy. In most cases, there would not be a loss on the exercise of options. Even if there were, there may be policy reasons for excluding the loss from deductibility. The employee has a choice as to

35 51 TLR 333, 334.

36 KPMG, (May-June 1998)1(3) *India Newsletter*.

37 For example, in India, by virtue of s 16 of the *Income Tax Act* only two types of deductions are permissible from salary income: standard deductions and professional tax. No other outgoing would qualify for a deduction.

whether to exercise an option. Allowing deductibility for such a loss may distort the purpose of ESOPs and any associated tax concessions.[38]

It is possible that even in the period after the exercise of the options, the employee may not be free to enjoy the securities/right for a prescribed time. This may be because of lock-in covenants applicable beyond the date of exercise. If the employee does not have a right of disposal, then economically (as discussed above) it may not be justifiable to tax the benefit received on exercise of options as a part of salary. An employee may also argue for depressing the value of the shares because of the restrictive covenants attached to the ownership and enjoyment of such shares.

It is normal for a time gap to be stipulated between the grant of an option and its exercise. In between these two points of time, there may be a movement in the prices of the underlying shares, which could be significant. A movement in the share price is because of financial market forces. It cannot therefore reflect an equitable remuneration for an employee's services and performance. This is another theoretical argument against taxing the benefit at the time of the exercise of the options.

Further, the date of exercise of the options by all the employees may not be uniform. Therefore, the quantum of benefit to be taxed may not be the same, reflecting the variation in the movement of the price of the shares between the times of exercise by each employee. Employees who have hypothetically rendered identical services may be taxed dissimilarly, merely because the date of exercise of the options is different. Theoretically, it is appropriate that employees who have given uniform service should be taxed identically.

Despite the theoretical limitations, quite a few countries currently tax the benefit at the time of exercise and further attribute it as arising out of employment.[39] In India, when ESOPs came into vogue, there was no specific provision in the law to tax such benefits. A circular of the Central Board of Direct Taxes[40] and a ruling of the Authority for Advance Ruling[41] favoured taxation of the benefit at the time of the exercise of the options.

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38 For a discussion of this issue in the context of the introduction of a capital gains tax and the deductibility of capital losses, see RW Parsons, 'Capital Gains Taxation – A Lawyer's Perspective' (1984) 1 *Australian Tax Forum* 122, 143.

39 Most countries that do follow Lord Denning's view in *Abbot v Philbin* (above). For example, in Germany, the employee will derive a benefit on exercise of an option and it is classified as employment income. The benefit is subjected to income tax, solidarity surcharge and church tax (if applicable) under s 19 of the German Income Tax Code. See further, Hagen, above n 6, 315.

40 Circular No 710 of 24/8/95.

41 P No 35 of 1995, reported in 235 *Income Tax Reports* 635.

If tax has been levied at the time of grant, countries, without exception, treat profits at the time of exercise as capital gains.[42] Exchange of an option into a share may then be regarded as a transfer subject to capital gains tax. Most countries, for example, Australia[43] and Belgium,[44] do not tax unrealised gains at the time of exercise of options. It would contravene the principle that an employee should not be subjected to tax unless the gains have been realised.

Taxation at the time of sale

The benefit derived by an employee under an ESOP may also be taxed at the time of sale. Such income is normally taxed as capital gains.[45] The rationale is that, although the ownership of the asset has its origin in employment, the asset is to be regarded separately and independently.

However, in certain countries, such as France,[46] the profits on sale are split into two components: purchase gains and capital gains. The purchase gains are equivalent to the fair market value on the exercise date less the basis price. The capital gains are equal to the sale price less the fair market value on exercise date. Further, the purchase gains are taxable as salary if the sale of shares happens within a defined time from the grant. Otherwise, such benefits (purchase gains) are taxed as capital gains.[47]

Capital gains arising on sale are tax-free in certain countries. Belgium, for example, exempts capital gains on shares from taxation when they are related to private investment.[48] Germany does not normally tax capital gains realised on the sale of private property assets.[49]

A comparison of individual tax systems provides several tax models for both the time of taxation of ESOPs and the category in which any income or gain is taxed.[50]

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42 Mossner, above n 1, 101.
43 Bentley, above n 6, 298.
44 Muyldermans and Moeskops, above n 6, 309.
45 For example, in India under ss 47, 48 and 49 of the *Income tax Act 1961* read with section 45.
46 Mossner, above n 1, 101.
47 Ibid.
48 Muyldermans and Moeskops, above n 6, 309.
49 Hagen, above n 6, 317.
50 Sometimes the restrictions on ESOPs are such that they are not attractive to employees. Alternatively, private companies may not wish to dilute their ownership or to comply with restrictive legislative conditions. Phantom share schemes are common in such situations, where the employee's bonus is linked to the share value of the business. The tax implications are then usually no different from a normal bonus arrangement.

International tax aspects of ESOPs

In the context of the taxation of an ESOP, it is important to consider the international tax aspects. This is particularly so because of the increased mobility of labour. Companies are expanding and creating a presence in more than one tax jurisdiction, necessitating the movement of their personnel.

An important principle of international tax is that a taxpayer should ensure that sufficient income is earned and taxed in each jurisdiction to utilise the tax credits. Difficulty otherwise often arises in the country of residence in taking advantage of tax credits from other jurisdictions.[51]

The ordinary principle recognised in model conventions is that remuneration is to be taxed in a country where the employment is exercised.[52] This rule is subject to certain exceptions.[53] Primarily, however, salaries are to be taxed in a country where the services are performed. In the case of capital gains, especially those arising from the sale of shares, several treaties provide that the gains on sale are to be taxed in the country where the seller is a resident.[54]

As discussed above, there are different theories on the type and time of taxation of a benefit received under an ESOP. The classic methods of taxation would fail if countries taxed deferred remuneration at different times and under different heads of income. For example, consider options that are taxed at the time of grant in country A while they are taxed in country B at the time of sale. If the period and type of taxation differs, international double taxation could no longer be said to exist. When two countries do not tax the income under a uniform head, then different Articles of a Treaty would apply. If the point of taxation is not the same in all countries, the employee, being a resident of different countries at different points of time, may face double or multiple taxation. For example, an employee may be resident of country A on grant date. He may become a resident of country B on exercise date and a resident of country C on sale date. All three countries may attempt to levy a tax at different points of time because they have adopted different bases for taxing the benefit received under an ESOP.

Salary is covered under Article 15 of both the OECD as well as the UN model convention. The commentaries on Article 15 in both the model conventions are relatively uniform. The provisions of Article 15 are subject to certain other Articles dealing with specific components or type of salary, for example, articles

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51 Mossner, above n 1, 102.
52 Article 15 of the OECD Model Convention and Article 15 of the UN Model Convention.
53 Articles 16 to 20 of the OECD Model Convention.
54 See, for example, the treaty between India and Mauritius, Articles 13(4) and 13(5); and the treaty between India and France, Article 13(6).

governing pensions (Article 18), directors' remuneration (Article 16), the salary of artists and athletes (Article 17), and government employees (Article 19). The basis of taxation under these Articles may itself be different. Thus, a pension under Article 18 may be taxed in a country where the employee is a resident. Directors' remuneration may be taxed under Article 16 in a country where the 'employer' is resident. Salary of an employee of the government may be taxed in a country from where the payment originates. Remuneration of an artist may be taxed under Article 17 in the country where the activities are performed.

Despite a relative uniformity in the commentary and, therefore, the understanding of Article 15, certain issues can arise. Some of the issues in the context of an ESOP could be as follows:

Which Article of the Treaty is to be applied to tax the benefit received by an employee?

If the remuneration is to be taxed as salary, should it be in the country in which the employee carried out her or his employment? This could cause problems in situations where the country in which the employment has been exercised has no knowledge of the taxable event.

It is possible that the employer has a dual residence: in one country based on incorporation and in another based on control and management. There may not be a Treaty between the countries in which the employer has dual residence or, even if it does exist, there may be no tiebreaker provisions to resolve such issues.

Salaries may not be paid uniformly throughout the year. The employee may perform services in more than one jurisdiction during that period. Further, the responsibilities of an employee may be altered making it difficult to apportion the stock options granted between the two jurisdictions either on a time basis or a value (of services) basis.

A permanent establishment (PE) may be regarded as a taxable entity in the source country. The question is whether a person could be regarded as an employee of such a PE?

Whether an intermediary employer would also be covered? Whether in resolving such issues, the economic dependence test for authority would have to be applied?

Whether salary that has been taxed in one country can again be subjected to a tax in the other country?

The overwhelming view is that the benefit received under an ESOP is to be taxed as remuneration under Article 15.[55] There could be cases of double taxation where the employee gets taxed in more than one jurisdiction based on different taxable events that occur or are completed there. It is also possible, using the same logic, that the employee may benefit from double non-taxation through exemptions in those jurisdictions.

On an analysis of the various stages of taxation and the categories under which income is to be taxed, the various taxation possibilities could be summarised as follows.

	Country	Time of taxation	Taxed as
1	A	Grant	Salary income
	B	Grant	Salary income
2	A	Exercise	Salary income
	B	Exercise	Salary income
3	A	Exercise	Capital gains
	B	Exercise	Salary
4	A	Exercise	Salary
	B	Exercise	Capital gains
5	A	Sale	Capital gains
	B	Sale	Capital gains
6	A	Sale	Exempt
	B	Sale	Capital gains
7	A	Sale	Capital gains
	B	Sale	Salary
8	A	Grant	Salary
	B	Exercise	Salary
9	A	Grant	Salary
	B	Exercise	Capital gains
10	A	Grant	Salary
	B	Sale	Capital gains
11	A	Exercise	Salary
	B	Sale	Capital gains
12	A	Exercise	Capital gains
		Sale	Capital gains
13	A	Exercise	Salary/Capital gains
	B	Sale	Salary/Capital gains

55 Mossner, above n 1, 112.

In the previous table two countries would be involved when:

a An employee is a resident of country A, but working in country B.

b An employee is a resident of country A and also works in country A, but subsequently moves to country B.

It is also possible that three countries will be involved. This would happen, for example, when an employee is a resident of country A, works in country B and subsequently moves to country C.

To add to the possibilities reflected in the chart/table would be a situation where country A taxes the income at a single point in time, but country B segregates the total income into two components (say, salary and capital gains) and taxes them at two different points in time.

There would be further complications where one country follows the credit method of giving relief from double taxation, and the other country follows the exemption method.

Stock options given by a holding company

A variation of the issues arising out of the taxation of an ESOP is where stock options are given by the parent company to the employees of the subsidiary. In some jurisdictions, it could be arguable that the stock options and the benefit they give do not flow from the employer. The income, if any, could not then be categorised as salary. However, most countries, including India, provide that an amount paid directly or indirectly by or on behalf of an employer is to be taxed as salary.[56] The benefit given to the employee by the holding company would then be taxed as salary, using a substance over form approach. Even in this scenario, legal complications are bound to arise. Consider the situation where the holding company is not a 100% holding company. If, for example, a holding company owns only 51% of the share capital of the subsidiary, it could become more difficult to sustain an argument that stock options given to the employees of the subsidiary are an indirect form of remuneration to be taxed as a part of salary. It usually requires specific legislation that caters for such indirect payments.[57]

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56 In India, this is provided in s 15 of the *Income Tax Act 1961* and Ruling of the Authority for Advance Ruling P No 15, 235 ITR 565, India.

57 Another grey area in many jurisdictions relates to the status of ESOPs where there is a merger or acquisition that affects the shares or options covered by the scheme. The conditions required for special tax treatment of the scheme may be varied. This usually requires a taxation ruling from the relevant tax authority. See, eg, in Australia, Class Rulings 2001/18 and 2001/27.

Conclusion

Taxation of ESOPs raises issues in most jurisdictions that arise mainly from the determination of how they are to be characterised for tax purposes, the time of taxation and methods of granting relief from double taxation. The varying forms that ESOPs take, often in response to the taxation law, further complicate the situation. These problems are apart from the policy arguments, including that ESOPs do not foster horizontal equity, that they do not achieve the aim of extending general employee ownership of the company, and that they are an instrument of tax avoidance. Currently, there is no evidence of any attempt to converge and move towards an uniform system. On an analysis of the reasons underlying these problems, a few suggestions are possible in the international tax environment. For these to succeed, they would need to come under the auspices of the OECD and/or UN conventions.

One solution is for countries to agree to a uniform time at which to tax ESOPs. This would avoid the difficulty in sustaining a credit for foreign taxes in the home country. However, agreement on this is unlikely, given that the time of taxation depends on the domestic tax structure.

A more viable solution is one that does not affect the operation of domestic rules. The home country could give credit for the tax paid in the source country even though the tax is levied in different years of taxation. Alternatively, the country where the work is performed should have a right to tax the income irrespective of the category or classification under which such income is to be taxed. This relies on recognition at the international level of the whole ESOP transaction, rather than trying to deal with its components on a piecemeal basis under the existing convention articles.

As taxation policy seeks to recognise substance over form, it is important to view ESOPs at the international level, in the same way as they are generally given special treatment at the national level. The problem will become more acute as the labour market becomes more mobile. Increasingly, ESOPs are used to reward senior executives. As long as they fall within the favourable or particular treatment given to ESOPs in most jurisdictions, there is scope for significant double or non-taxation.