Tax Collection At Source on Remittances made by Indian Employees towards ESPP / other Equity Incentive Schemes of Foreign Entities, and Potential Solutions

1. Introduction

1.1 Section 206C of the Income Tax Act, 1961 ("Act") envisages a mechanism to collect tax at the source ("TCS") from the buyers of specified goods or services. The objective of TCS is to ensure that the Indian government gets its revenue at the earliest point of time and also to track transactions of high value. The seller or service provider who collects the tax deposits it with the government and file periodic returns. The buyer who pays the tax can claim credit or refund while filing personal income tax return ("ITR") in India

1.2 With a view to widen and deepen the tax net, Sub-section (1G) to Section 206C of the Act was introduced effective from October 1, 2020 pertaining to TCS on broadly two types of remittances out of India made under (i) the Liberalized Remittance Scheme ("LRS") of the Reserve Bank of India ("RBI"), and (ii) overseas tour program packages. The relevant TCS rates were further updated through the Finance Act, 2024.

1.3 Under the LRS, individual residents in India are allowed to remit funds outside India up to US$ 2,50,000 per financial year (April to March). Though this LRS limit does not apply on the remittances made by the Indian resident employees or directors of a Foreign entity or its subsidiary or investee company in India (referred to as "Indian Employees") to participate in an Employee Share Purchase Plan ("ESPP"), or other Share-based Employee Benefit Plans (collectively referred to as "Equity Incentive Program" or "EIP") of a Foreign Entity, such remittances are reckoned as LRS for reporting purposes under India's Foreign Exchange Management Rules.

1.4 The tax implication for the Indian Employees (intending to remit purchase price under a foreign EIP) germinates from the categorisation of their remittance as LRS.

2. The Problem Statement

2.1 As per the prevailing provisions of Section 206C(1G) of the Act, any remittance by an Indian Employee towards a foreign EIP for an amount exceeding INR 700K (or ~USD 8400, "TCS Threshold") shall be subject to TCS at 20% in India. This tax is collected by the Authorised Dealer or Bank ("AD") through which outward remittance is made.

2.2 This can be better understood by following instance:

All figures are in USD

1	Offer under EIP during FY 2024 - 2025		200 Shares
2	Fair Market Value ("FMV") per share as on date of purchase[1]		150
3	Less: Discount per share w.r.t. FMV above		- 50
4	Offer price per share		100
5	**Total remittance required by Foreign Entity**		**20,000**
6	Threshold remittance for triggering TCS (~)	8,400	
7	**Total actual remittance (grossed up for TCS@20%)**	**22,900**	
8	TCS by AD in India [20% of (22,900-8,400)]	- 2,900	

2.3 Immediate tax implications:

a) Personal tax

i) A total of USD 10,000 [50x200] is treated as taxable perquisite a part of salary and is taxed at applicable salary tax rate after considering this taxable perquisite.

ii) Assuming a salary tax rate of 31.2%, USD 3,120 is withheld by the Indian employer under Section 192 of the Act and deposited with the Indian tax authorities.

b) TCS on remittance (subject matter of this write-up)

i) USD 2,900 is an additional cash outflow by Indian Employee and is collected and deposited by the AD with the Indian tax authorities.

ii) The AD issues a certificate of TCS in favour of the Indian Employee. The Indian Employee, then, takes credit or refund of the TCS in his/her ITR for the relevant financial year.

iii) The TCS amount is not lost but is taken credit or refund of, however after a period say from the date of TCS up to the date of claim or refund which may be more than a year.

[1] *Valuation as per report of Category-1 Merchant Banker registered with the Securities and Exchange Board of India. This is required to determine personal tax of Indian Employees and corresponding tax withholding by the Indian employer. This is required even if the shares of the Foreign Entity are listed outside India. Qapita's subsidiary is a 'Registered Category-1 Merchant Banker' in India.*

2.4 As in any case, as the Indian Employees pay personal tax (through tax withholding by Indian employer) on the resultant gains upon exercise or acquisition of shares, any further tax withholding by the AD is perceived as unnecessary and cumbersome. Well, this is the tax provision as on day.

2.5 Whereas, whether this TCS provision is justified or not at all in an EIP context may be represented to the Government of India for its kind consideration, separately; in this write-up, some potential solutions are deliberated.

3. Potential Solutions

3.1 Any solution devised should pass the test of compliance in letter and spirit in relation to India's applicable laws of taxation and foreign exchange.

3.2 The key lies in such transaction structure that avoids either (i) breaching the TCS Threshold in a financial year, or (ii) remittance individually by the Indian Employees as that would amount to LRS, or (iii) both, being the pre-requisites for application of TCS under Section 206C(1G) of the Act.

3.3 Few instances of alternative feasible solutions[2] could be:

a) **Splitting of remittance:** If the offer under EIP is one-off requiring only remittance of size approximately the double of the TCS Threshold in a single financial year, the total remittance may be split. Say, ~ one half may be in the month of March and balance in April of the same calendar year.

b) **Reduction of offer size:** If the offer under EIP is a continuous program (say participation in an ESPP with a savings feature) requiring a sum total of remittances in a financial year exceeding the TCS Threshold, such offer may be reduced to bring it below the TCS Threshold.

[2] *Cashless exercise to the extent of amount of remittance can be a solution for most of the EIPs except for an ESPP with a savings feature in a long-term. Thus, cashless exercise is not elaborated further.*

c) **Rationalization of salary:** In case the reduction in the offer (stated above) is material, the monthly or annual salary may be rationalised (in fact cut-short) to the extent of such excess, and additional shares may be issued by the Foreign entity with the value equivalent to such excess without requiring any additional remittance. Salary to the extent rationalised shall albeit appear in the salary slip but as an EIP perquisite. This would not impact the pay slip conscious employees.

d) **Remittance or Set-off by Indian Employer:** The amount payable by the Indian Employees may be deducted locally with the Indian employer making either (i) a remittance of the deducted amount along with EIP cost recharge to the Foreign entity, or (ii) an inter-company setoff to the extent allowed as per applicable laws of the country of the Foreign entity. Inter-company set-off may be acceptable to the Reserve Bank of India as does not involve any outward remittance; however, needs to be checked from transfer pricing aspects in both the countries.

e) **Provision of interest free advance:** The local Indian employer may provide interest free advance to the extent of TCS collected by the AD upon submission of proof. This advance may assist in cashflow management of the Indian Employees until the presumed refund of the same say by end of October of the next financial year immediately following the financial year for which TCS is collected by the AD. However, the interest free element in the advance may create an additional personal tax impact on the Indian Employees.

4. Our views

4.1 TCS is really not a “definite charge of tax”, but an “advance collection of money” to secure tax arising out of potential disposition of the shares acquired under an EIP. Practically, this results in tax refund unless the Indian Employees really make a capital gain out of such acquired shares in the same financial year. Thus, it essentially indicates a cash flow problem for a period rather than a tax loss

4.2 Owing to this and particularly given the fact that each company may have different severities of situation, a rule-based solution seems effective in general, where two classes of Indian Employees may be created – (i) whose cashflow is not materially impacted (say less than 10% total annual cash compensation), and (ii) others. For the first category, status quo may be adopted; whereas for the other category, one or more combinations of solutions may be examined.

About Qapita

Qapita is a leading provider of Equity Compensation solutions for startups, unlisted and publicly listed companies. Our service offerings cover the entire life cycle of ESOPs including Plan conceptualization, Design, Documentation, Plan management, Compliance and Reporting. We have serviced over 1800+ clients across all industries, domestic and international, listed and unlisted. Our team consists of experienced professionals specialising in conducting preliminary analysis, planning, designing, and implementing ESOPs. Each of our consulting team members is a qualified Chartered Accountant/ Company Secretary, a market leader in Equity Management and Marketplace solutions for unlisted and listed companies in India and South East Asia.

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