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2006 Update to Granting Stock Options in India

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This is an overview of the legal and strategic issues related to a U.S. parent company granting stock options to employees of its Indian subsidiary, including consideration of exchange controls, securities laws and obtaining possible tax benefits for an optionee.

Strategy

Before implementing a compensation scheme, a company must evaluate its likely effectiveness in incentivizing and retaining employees. Options, to the extent they inspire loyalty and commitment and provide employees with a sense of ownership, are an important compensation tool. Indian employees in the information technology and biotechnology sectors generally are familiar with this type of compensation and at least higher level employees view options favorably. Lower level employees may prefer cash.

Securities Law Considerations

India's securities laws do not impose any restrictions on the grant to employees in India of stock options by a U.S. company. Companies may offer stock options to employees of a subsidiary in India either directly or indirectly. U.S. securities laws will not be an issue so long as the options are granted under a plan which is either in compliance with S.E.C. Rule 701 and applicable state law or has been registered with the S.E.C. on a Form S-8.

Currency Control Considerations

India's currency exchange controls applicable to option exercises by employees have been liberalized. There is presently no limit on the amount that employees or directors are allowed to remit for this purpose so long as the U.S. company owns at least 51% of the India subsidiary and any proceeds from a sale of the shares is repatriated to an account in India. A purchase of U.S. company shares by persons other than employees or directors of the India subsidiary, under an equity incentive plan or otherwise, remains subject to monetary limits (presently $25,000 per year per Indian resident) under India's foreign exchange control regulations.

Effective with the publication on April 5, 2006 of RBI/2005-06/253, the Reserve Bank of India ("RBI") allows authorized foreign exchange dealers to handle remittances abroad for acquiring shares under stock option plans, provided the dealer verifies: (i) the foreign issuer owns at least 51% of the India subsidiary that employs the employees exercising the stock options; (ii) the shares are being offered by the foreign issuer globally on a uniform basis (which we understand to mean that the stock option program in India should not have terms that are different from the terms generally applicable to employees elsewhere in the world) and (iii) the India subsidiary files an annual return with the RBI disclosing the remittances and the beneficiaries furnished by the RBI that is submitted to the RBI through an "Authorised Dealer" bank).

The requirements for global uniformity and for filing of annual returns are new conditions enacted in April 2006 and apply to all employers in India. The global uniformity requirement may be interpreted to prevent stock option plans of non-Indian companies from qualifying for certain beneficial treatment under the Indian Income Tax Act. This is covered below under "Tax Consequences".

The RBI has also granted general permission to foreign companies to repurchase shares issued to their employees in India under stock option plan. Previously, such a repurchase required advance approval from the RBI. Now such approval is unnecessary if the following requirements are met: (i) issuance of the shares was in accordance with the exemptions above, (ii) the terms of the repurchase were specified in the initial option agreement (and have not been amended since); and (iii) the India subsidiary is current in filing its annual returns with the RBI providing details of remittances/beneficiaries/etc.

The general authorization for repurchase of shares appears to be in addition to the existing general permission to the optionees to sell their shares after exercise. A voluntary sale by the employee (unlike an involuntary repurchase compelled by the employer in compliance with the above requirements) is subject to the condition that the sale-proceeds are immediately remitted to an account with an "Authorised Dealer" bank in India (in any case not later than 90 days from the date of such sale).

Employment Issues

Like the United Kingdom, employees in India generally have a written employment agreement. If the employment agreement expressly states that the grant of equity compensation is entirely within the employer's discretion, or makes no mention of equity compensation being part of the employee's pay, then it is unlikely that an employee can claim any special or ongoing entitlement to additional equity compensation although there is no harm in expressly stating this in the stock option agreement. Data privacy is a concern around the world now, no less in India than in the U.S., so it is advisable to obtain the employee's consent to sharing personal information with persons outside India as part of the administration of the stock option program.

Tax Consequences

Generally, an employee in India will recognize taxable income on exercise of the stock option based on the difference between the price paid for the shares and the fair market value of those shares on the date of exercise. This income will be subject to withholding by the U.S. parent company, failing which the Indian employer would become liable to pay the withholding tax as a representative of the U.S. parent company.

If the plan complies with certain tax guidelines, however, and is registered with India's Chief Commissioner–Income Tax of the state where the subsidiary is incorporated, the options will have the same beneficial tax treatment as federal tax treatment of incentive stock options in the United States. For an option granted under such a tax-favored plan, taxation does not occur on option exercise, but is deferred until sale of the stock and also is not subject to withholding by the employer. The U.S. company needs to review its stock option plan to ensure it conforms to the Indian government guidelines and file the plan with the Indian tax authorities. The guidelines require that the plan include, among other things, the following:

- Number of shares to be issued overall,
- Class(es) of employees eligible to participate,
- Manner in which the price at which shares at to be sold will be determined (significant additional detail is required for a private company),
- Deadline for obtaining shareholder approval and the manner in which it will be obtained, and
- Conditions affecting the transferability of shares.

There is a further limitation in the guidelines that an employee who is a promoter or belongs to the promoter group or a director who directly or indirectly holds over 10% of the outstanding equity shares of the company, may not be eligible to participate in the tax-favored stock option plan. Since the stock option plan for a U.S. company may not contain such a restriction, the U.S. plan would be non-compliant with this limitation and therefore ineligible for registration. In the past, to overcome this limitation a U.S. company would create a sub-plan for employees in India with conditions that were otherwise identical to the master plan, but with a stipulation that none of the beneficiaries of this sub-plan would breach the 10% rule. With the RBI now stipulating global uniformity, there is uncertainty on the sub-plan approach. Persons who are not employees or directors must be excluded from eligibility to receive stock options under a registered plan.

If the India subsidiary is required to reimburse the U.S. company for the spread on the option exercise, then it may be possible for the India subsidiary to claim the reimbursement as a deduction from its taxable income subject to India's taxes. Whether this position can be defended is highly uncertain at present, however, and should not be undertaken without first obtaining an opinion of tax counsel in India.

As mentioned earlier, if the plan is not registered, the difference between the exercise price and the fair market value of the shares at the time of exercise is treated as a taxable compensation/perquisite paid by the employer and subject to withholding of tax. Either the Indian subsidiary or the U.S. parent company would be required to make this withholding and pay the tax withheld to the tax authorities.

Conclusion

India currently generally presents a welcome climate for stock options grants to employees of subsidiaries in India of U.S. companies. Nonetheless, implementing an equity-based compensation program in India still presents some challenges and should be done carefully with the advice of a chartered financial accountant or attorney in India.

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