Executive Compensation Alert: 2009 Update on Stock Options in India

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1. 2009 UPDATE ON GRANTING STOCK OPTIONS IN INDIA

This is an overview of some 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 tax burdens. ***Of particular significance*** is an August 2009 change in India's tax laws that significantly eases the administrative and financial burdens on using stock options as compensation in India and is retroactive to April 1, 2009. This change in tax law means employees in India whose options are exercisable only while the issuer's shares are publicly-traded can now exercise their stock options as freely as their American counterparts (subject to a comparable tax withholding obligation).

2. 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.

3. TAX CONSEQUENCES

New Law: Fringe Benefits Tax on Employer Replaced with Perquisite Tax on Employee

Retroactive to April 1, 2009, the exercise of a stock option by an employee in India results in the employee recognizing taxable "perquisite" income equal to the difference ("spread") between the price paid for the shares and the fair market value of those shares on the date of exercise. Such fair market value on the date of exercise will then be considered as the cost of acquisition for computing capital gains on sale of the shares by the employee. The new tax treatment therefore, is essentially identical to the tax treatment in the U.S. of the exercise of a "non-qualified" (or "non-statutory") stock option. Employers with compensatory stock options granted prior to April 1, 2009, will be relieved to learn that such stock options also come under this tax treatment rather than continuing to require the employer to pay a flat fringe benefits tax ("FBT") of 33.99% on the difference between the price paid for the shares and the fair market value of those shares on the date of vesting.

Perquisite Tax

As noted above, as of April 1, 2009, the exercise of a stock option by an employee (or former employee) in India results in classification of the difference between the price paid for the shares and the fair market value of those shares ***on the date of exercise*** as "perquisite" income. "Perquisite" income is taxable to the employee, but the employer is required to withhold tax at exercise at the income tax rate applicable to individual taxpayers (presently 30.9% at the highest income bracket) and remit the withheld tax to the tax authorities no later than 7 days from the date of payment of salary for the month in which the exercise occurred. Previously, the determination of "fair market value" was required to be made by an India-licensed Category I merchant banker. At this time it is unknown whether this will still apply. It is to be hoped that companies based outside India will be able to use the determination method(s) they generally employ for all other compensatory stock option exercises.

Prior Remittance of FBT on Option Exercises Occurring After March 31, 2009

Previously, employers have been required to estimate and remit FBT payments in advance of actual option exercises. Employers that remitted estimated payments of FBT for exercises that took place after March 31, 2009, will need to obtain a refund or credit by applying to the tax authority. However, there is not yet a formal process to process such requests for refund/credit.

Many employers require their employees to reimburse them at the time of exercise for the amount of FBT the employer is required to remit. With respect to such amounts collected due to an exercise that took place after March 31, 2009, employers will want to reimburse employees for any excess amount collected after ascertaining how the excess amount remitted to the government will be applied (for example, used to satisfy the perquisite-tax withholding or refunded to the employer, or applied toward other tax due from the employer).

Prior Tax-Favored Stock Option Arrangements Remain Irrelevant

Prior to April 1, 2007, the Indian tax regime provided favorable tax treatment for stock options that met certain conditions. The current law does not restore such treatment to the exercise of such stock options. The exercise of such a stock option results in recognition of perquisite income as with any other stock option.

Practical Considerations

There are some practical problems to implementing the new regulations. In many cases, it is likely that the monthly salary of the employee is less than the withholding tax on the exercise of the options. The pragmatic solution to such a scenario would be for the employee to do a same-day sale along with the exercise of the options. The U.S. broker who effects the sale should then be required to remit only the net sale proceeds to employee after deducting both the amount of perquisite tax required to be withheld by the employer and the exercise price.

4. 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 Rule 701 of the U.S. Securities and Exchange Commission ("SEC") and applicable state law or has been registered with the SEC on a Form S-8 registration statement.

5. 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 $200,000 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 that is submitted to the RBI through an "Authorised Dealer" bank). The requirements for global uniformity and for filing of annual returns apply to all employers in India.

The RBI has also granted general permission to foreign companies to repurchase shares issued to their employees in India under a 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).

6. EMPLOYMENT ISSUES

As in 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.

7. DATA PRIVACY

Data privacy is a worldwide concern 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. India's close legal history with the United Kingdom suggests it may eventually follow the European Union's privacy practices to an even greater degree.

8. CONCLUSION

Overall, India presents a welcome climate for investment and its economy continues to grow albeit at a somewhat slower pace due to the global economic downturn. With the recent change to India's tax laws there is greater flexibility in structuring compensation packages and a greater ability to align the interests of employees with those of their employer's stockholders.

With respect to equity compensation practices, all employers should consult with a chartered accountant or attorney in India to evaluate the best approach under their circumstances at the time.

For more information on this, or related matters, you may wish to contact any attorney in the Executive Compensation and Employee Benefits Group:

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