Executive Compensation Alert

India Proposes that Employers Pay a 35% Tax on Stock-Related Compensation

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PROPOSED LAW

The Government of India's proposed budget for 2007-2008 (commencing April 1, 2007) includes extending the 35% fringe benefit tax imposed on employers to the income their employees in India recognize on exercise of compensatory stock options. The income would be the difference between the price paid for the shares and the fair market value of the shares on the date of exercise. Although still subject to some negotiation, it appears more likely than not that this law will take effect as proposed on April 1, 2007. Thus, for stock options that have already been granted to persons in India it appears to be desirable for the employer to encourage these persons to exercise these options, at least with respect to vested shares, prior to April 1, 2007, and thereby avoid this tax treatment. It appears that going forward, the terms of a stock option agreement could include a provision requiring that on exercise the employee reimburse the employer for the amount of this tax paid by the employer. This would be similar to the practice that has developed with respect to stock options granted to employees in the United Kingdom. The UK government also imposes a sizable tax on the employer when the employee exercises an in-the-money stock option, but the UK tax authority has established a process by which the employer can require the employee to reimburse the employer for this tax. With respect to India however, labor laws need to be reviewed to determine if tax shifting is permitted.

ANTICIPATED EFFECT

Several effects can be reasonably anticipated if this proposal is enacted. First, stock options will be more selectively granted to employees and will be a less attractive way to incentivize employees. Another consequence is that prospective employees in India will negotiate instead for higher forms of other compensation, particularly cash. To the extent that much current investment in India has been in the technology and knowledge sectors by newly-formed, cash-tight enterprises it can be expected that this will discourage such activity. Current employers in India that granted stock options to employees in India and therefore find themselves, faced with an uncapped tax liability for which they had not planned or negotiated (the UK, at least, applied their tax to option grants that occurred after it took effect), will be further encouraged to reduce their investment in India in favor of other locations. It is not clear how this will affect foreign parent companies that have granted options to employees of their India subsidiary.

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