



Labour and Employee Benefits

Volume 2: Employee Share Plans

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Country Q&A

India

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EMPLOYEE PARTICIPATION

1. Is it common for employees to be offered participation in an employee share plan?

It has become typical, since the growth in the Indian information technology sector, for information technology companies to offer employee share options. In the last several years, the trend has also become popular in several other sectors such as the telecommunications, financial service, outsourcing, pharmaceutical and retail sectors. However, traditional sectors, such as manufacturing, have yet to see share option grants to employees.

Companies generally aim to attract and retain talented employees by offering them participation in company growth and making them stakeholders. Start-ups often find it a convenient mode of recruitment due to the unavailability of cash reserves.

2. Is it lawful to offer participation in an employee share plan where the shares to be acquired are shares in a foreign parent company?

The exchange controls laws permit a foreign parent company to grant share options to employees in India. The Foreign Exchange Management Act, 1999 (FEMA) (along with the relevant regulations) allows an individual resident in India to:

- Acquire shares under a cashless employees' share option plan (ESOP) issued by a company outside India.
- Purchase equity share offers under a foreign company's ESOP schemes, if the individual is an employee or director of:
 - an Indian office or branch of the foreign company;
 - a subsidiary in India of the foreign company;
 - an Indian company in which the foreign company has a direct or indirect equity holding of at least 51%.

If the individual qualifies as above, Indian banks permit the individual to remit funds for the purchase of a foreign company's shares under an ESOP scheme, irrespective of whether the shares are offered directly by the issuing company or indirectly through a trust, special purpose vehicle or step down subsidiary. However, the following conditions must be met:

- The foreign company must issue shares globally on a uniform basis.
- The Indian company must submit a report to the Reserve Bank of India (RBI) annually.

If these conditions are not met, Indian resident individuals can still purchase a foreign company's shares under the Liberalised Remittance Scheme (LRS) introduced by the RBI. Under the LRS, an individual is permitted to remit up to US\$200,000 (as at 1 August 2010, US\$1 was about EURO.77) per financial year (1 April to 31 March), provided certain conditions are met.

This represents a considerable liberalisation as a decade ago a foreign parent company could grant options only at a reduced price or on a cashless basis.

SHARE OPTION PLANS

3. Please list each type of share option plan operated in your jurisdiction (if more than one).

The traditional ESOP continues to be predominant in India.

4. In relation to the share option plan:

- What are the plan's main characteristics?
- Which types of company can offer the plan?
- Is this type of plan popular? If so, among which types of company is this plan particularly popular?

ESOP

Main characteristics. ESOPs in India have broadly the same characteristics as seen globally. Options are granted subject to a vesting schedule that is typically linked to tenure and/or performance. On vesting of options, employees have the right to exercise the options. On payment of exercise price, shares are issued to the employees and the employees become members of the company.

If an ESOP is issued by a company whose shares are listed (or going to be listed) on a recognised share exchange in India, the company must comply with the Securities and Exchange Board of India (Employee Share Option Scheme and Employee Share Purchase Scheme) Guidelines, 1999 (SEBI ESOP Guidelines). Some of the important provisions of the SEBI ESOP Guidelines are:

- ESOPs cannot be issued to promoters or members of the promoter group.
- ESOPs cannot be issued to directors if they hold more than 10% of the outstanding equity shares of the company.
- ESOPs can be issued only after making certain disclosures to employees.



- A compensation committee (consisting of a majority of independent directors) must be appointed to formulate the ESOP's terms and conditions, including:
 - the number of options to be granted per employee and in aggregate;
 - conditions under which vested options lapse (such as employment termination);
 - the exercise period and employee's right to exercise;
 - a procedure for making fair and reasonable adjustments in the event of any corporate actions.
- A compensation committee must frame policies to prohibit insider trading and fraudulent and unfair trade practices.
- Shareholder approval is required in order to grant share options.
- A separate, further shareholder approval is required for the grant of options to either:
 - employees of a subsidiary or holding company;
 - individual employees receiving 1% or more of the issued capital of the company in a single year.
- Restrictions on variations to ESOP terms to the detriment of the employees.
- Restrictions on the pricing of the options.
- A lock-in period of at least one year before vesting.
- Restrictions on the options' transferability.

Types of company. ESOPs can be issued by any company incorporated under the Companies Act, 1956 of India (Companies Act) and both private and public companies issue share options to their employees. Listed companies must comply with the SEBI ESOP Guidelines while unlisted public companies must comply with the Unlisted Public Companies (Preferential Allotment) Rules 2003.

Popularity. See *Question 1*. It is common to restrict the grant of options to senior and mid-level employees.

5. In relation to the grant of share options under the plan:

- Can options be granted on a discretionary basis or must they be offered to all employees on the same terms?
- Is there a maximum value of shares over which options can be granted, either on a per-company or per-employee basis?
- Must the options have an exercise price equivalent to market value at the date of grant?
- What are the tax and social security obligations arising from the grant of the option?

ESOP

Discretionary/all-employee. It is possible to grant options on a discretionary basis. The factors that are considered may include, among other things, the employees':

- Tenure.

- Experience.
- Performance.
- Past contributions.

The number of options granted may be negotiated between a company and a prospective employee.

Maximum value of shares. Options are typically granted at an exercise price that is equal to or over the shares' face value. The SEBI ESOP Guidelines give restrictions on the issue of options to promoters or directors and shareholder approval may be necessary in some circumstances (see *Question 4, ESOP: Main characteristics*).

If the exercise price is to be lower than the face value of shares, government approval may be necessary.

The face value of the shares to be allotted under the ESOP by a listed company to non-resident employees cannot exceed 5% of the paid-up capital of the issuing company when an Indian company issues options or shares to employees abroad (either direct employees or employees of a joint venture or wholly owned subsidiary) (*Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations 2000*).

Market value. The SEBI ESOP Guidelines allow a company to determine the exercise price, subject to the prescribed accounting policies. The compensation committee can make fair and reasonable adjustments to the exercise price in corporate actions such as rights issues, bonus issues, mergers, sales of divisions and so on. Companies are also allowed to reprice unexercised options (whether or not vested) if the ESOPs are rendered unattractive due to a fall in the shares' market price.

Tax/social security. There are no social security obligations arising from the grant of ESOPs and tax is not levied at the time of grant.

6. In relation to the vesting of share options:

- Can the company specify that the options are only exercisable if certain performance or time-based vesting conditions are met?
- Are any tax/social security contributions payable when these performance or time-based vesting conditions are met?

ESOP

Exercisable only on conditions being met. Vesting of options is typically linked to tenure but may also be linked to company or individual performance for employees at higher management levels.

Tax/social security. Social security contributions are not due on vesting of share options. Tax is not levied at the time of vesting, irrespective of whether the vesting is time or performance based. However, in situations where the date of exercise may coincide with the date of vesting, or if there is no exercise (for example, in the case of RSUs), tax may be levied at the time of vesting.



7. Do any tax or social security implications arise when the:

- Option is exercised?
 - Shares are sold?
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ESOP

Tax/social security on exercise. The grant of share options to employees is regarded as an employee benefit and tax is levied at the time of exercise of the option. The difference between the fair market value of the shares at the time of exercise and the exercise price paid is subject to tax at the employee's marginal rate of tax (the maximum marginal rate of tax is 30.9%). The fair market value is determined by prescribed rules and every Indian or foreign company (except Indian companies whose shares are listed on a recognised stock exchange in India) offering shares to Indian residents must have a share valuation under these rules. The employer subsequently withholds these taxes and deposits them with the government within the applicable time frame. Social security contributions are not payable at the time of exercise of options.

Tax/social security on sale. Tax is levied on sale of the shares acquired under the plan. The difference between the sale consideration and the fair market value of the shares on the date of exercise of the options is regarded as a capital gain income subject to tax at either:

- 20.6% for long term gains (shares held for a period exceeding one year).
- 30.9% for short term gains (shares held for a period equal to or less than one year).

There are no withholding obligations on the employer, and the employee must deposit the taxes by way of advance tax instalments. Social security contributions are not payable on exercise of the options.

SHARE ACQUISITION OR PURCHASE PLANS

8. Please list each type of share acquisition or purchase plan operated in your jurisdiction (if more than one).

The most common share acquisition plan in India is an employee share purchase plan (ESPP). Sweat equity shares are also commonly granted to founders or promoters.

9. In relation to the share acquisition or purchase plan:

- What are the plan's main characteristics?
 - Which types of company can offer the plan?
 - Is this type of plan popular? If so, among which types of company is this plan particularly popular?
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ESPP

Main characteristics. As with share options, in an ESPP, the shares are issued upfront but are subject to certain restrictions.

Listed companies must comply with the SEBI ESOP Guidelines when issuing ESPPs. Some of the requirements are:

- ESPPs cannot be issued to promoters or members of the promoter group.
- ESPPs cannot be issued to directors if they hold more than 10% of the outstanding equity shares of the company.
- The shareholders must approve the share issue under the ESPP and certain grants of share options (*see Question 10, ESOP: Maximum grant of shares*).
- A lock-in period of a minimum of one year from the date of allotment of shares.

The company has freedom to price the shares, provided it complies with the specified accounting policies.

Types of company. ESPPs may be issued by any company incorporated under the Companies Act.

Popularity. ESPPs are far less popular than ESOPs. In addition, promoters and entrepreneurs generally prefer to issue options to employees, since issue of shares upfront would make employees owners of the company immediately.

Sweat equity shares

Main characteristics. Sweat equity shares are issued either at a discount on the face value or without any consideration. They are issued to employees, promoters or directors as consideration for, for example, providing know-how, intellectual property or otherwise adding value.

Sweat equity shares can only be issued in a class of equity shares that have already been issued by the company (*Companies Act, Securities and Exchange Board of India (Issue of Sweat Equity) Regulations 2002 and Unlisted Companies (Issue of Sweat Equity Shares) Rules 2003*). Sweat equity shares are considered at par with other equity shares of the same class. Sweat equity shares issued by a listed company are subject to a lock-in of three years from the date of allotment.

Types of company. Any company incorporated under the Companies Act can issue sweat equity shares. SEBI ESOP Guidelines also permit an issue of ESPP as part of a public issue of shares. However, the Companies Act prohibits the issue of sweat equity shares by a company before one year from the date it was entitled to commence business.

Popularity. Companies use sweat equity shares on a case-by-case basis. They are not as popular as ESOPs.

10. In relation to the initial acquisition or purchase of shares:

- Can entitlement to acquire shares be awarded on a discretionary basis or must it be offered to all employees on the same terms?
 - Is there a maximum value of shares that can be awarded under the plan, either on a per-company or per-employee basis?
 - Must employees pay for the shares and, if so, are there any rules governing the price?
 - Are any tax/social security contributions payable when the shares are awarded?
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ESPP

Discretionary/all-employee. ESPPs can be offered on a discretionary basis or to select employees. However, the company must



include the appraisal process for determining the eligibility of employees for the ESPP in the explanatory statement to the notice issued to the shareholders (*SEBI ESOP Guidelines*). The shareholders can also allow offers of different numbers of shares for different categories of employees.

Maximum value of shares. There is no specified maximum value of shares. Besides restrictions on allotment of shares to promoters or directors, the SEBI ESOP Guidelines require shareholder approval for the allotment of shares to either:

- Employees of subsidiary or holding companies.
- Employees receiving 1% or more of the issued capital of the company in a single year.

Payment of shares and price. Unlike sweat equity shares, employees must pay for subscribing to shares under an ESPP. There is flexibility in determining the price, although if the price is lower than the shares' face value, government permission may be necessary. Listed companies must comply with the accounting policies for pricing the shares under the SEBI ESOP Guidelines.

Tax/social security. Tax is levied on the difference between the fair market value of the shares and the exercise price at the time that the shares are allotted to the employee. The valuation must be done by a merchant banker for shares awarded by unlisted Indian companies and all foreign companies. The employer is responsible for withholding these taxes and depositing with the Indian government within the applicable time frame.

Social security obligations do not arise on allotment of shares under ESPP as they are not included under the definition of basic wages under the EPF Act.

Sweat equity shares

Discretionary/all-employee. Sweat equity shares can be offered to permanent employees or directors on a discretionary basis. A shareholder resolution must specify the class or classes of directors or employees to whom sweat equity shares are to be issued (*Companies Act*).

Maximum value of shares. Unlisted companies require prior government approval to issue sweat equity shares for more than either (*Unlisted Companies (Issue of Sweat Equity Shares) Rules 2003*):

- 15% of the total paid-up equity share capital in a year.
- Shares with a value totalling INR50 million or more (as at 1 August 2010, US\$1 was about INR46.6).

In addition, sweat equity shares form part of managerial remuneration and therefore must comply with the managerial remuneration ceilings under the Companies Act.

Payment of shares and price. Payment for sweat equity shares can be in the form of cash consideration or for other consideration such as intellectual property rights, know-how or some other addition of value.

For listed companies, under the SEBI (*Issue of Sweat Equity*) Regulations 2002, the pricing of sweat equity shares cannot be less than the higher of the following:

- The average of the weekly high and low of the closing prices of the related equity shares in the six months preceding the relevant date (which is 30 days before the date of the shareholders' meeting).
- The average of the weekly high and low of the closing prices of the related equity shares during the two weeks preceding the relevant date.

If sweat equity shares are issued for non-cash consideration, the valuation of the shares must be carried out by a merchant banker.

Tax/social security. This is the same as for ESPPs (*see above, ESPP: Tax/social security*).

11. In relation to the vesting of share acquisition or purchase awards:

- **Can the company award the shares subject to restrictions that are only removed when performance or time-based vesting conditions are met?**
- **Are any tax/social security contributions payable when these performance or time-based vesting conditions are met?**

ESPP

Restrictions removed only on conditions being met. ESPPs are typically issued based on restrictions, which are removed when performance or time-based conditions are met. If the employee is unable to comply with the requirements, the shares must be repurchased or bought back. The SEBI ESOP Guidelines give a minimum lock-in period of one year on allotment of shares, although there is some flexibility in the event of merger or amalgamation.

Tax/social security. No tax or social security contribution is due on vesting when the restrictions attached to the shares are removed.

Sweat equity shares

Restrictions removed only on conditions being met. It is not common for sweat equity shares to be issued with restrictions, except those of a general nature such as transferability and so on. However, sweat equity shares must be locked in for three years from the date of allotment (*SEBI (Issue of Sweat Equity) Regulations 2002 and the Unlisted Companies (Issue of Sweat Equity Shares) Rules 2003*).

Tax/social security. This is the same as for ESPPs (*see above, ESPP: Tax/social security*).

12. What are the tax and social security implications when the shares are sold?

ESPP

There are no social security implications when the shares are sold. Capital gains tax is levied on the difference between the sale consideration and the fair market value of the share on the date of allotment of the shares. The rate of tax depends on whether the gains are long term or short term in nature and whether the shares are listed in India. The rate of tax ranges between 0% to 30.9%.

Sweat equity shares

This is the same as for ESPPs (see above, ESPP).

PHANTOM OR CASH-SETTLED SHARE PLANS

13. Please list each type of phantom or cash-settled share plan operated in your jurisdiction (if more than one).

Phantom or cash-settled plans are uncommon in India. Companies have resisted the grant of phantom shares, share appreciation rights and so on, and most companies prefer to use a performance-based bonus plan rather than a phantom or cash-settled plan.

14. In relation to the phantom or cash-settled share plan:

- What are the plan's main characteristics?
- Which types of company can offer the plan?
- Is this type of plan popular? If so, among which types of company is this plan particularly popular?

Phantom/cash-settled plans

Main characteristics. Typically, a company indexes an employee's participation in the growth of the company in relation to the increase in its share value from the date of joining of the employee until vesting, based on which certain cash rewards are made.

Types of company. Listed companies typically use these types of plans.

Popularity. These plans are not widespread in India and are most common in foreign companies extending such plans to Indian subsidiaries.

15. In relation to the grant of phantom or cash-settled awards:

- Can the awards be granted on a discretionary basis or must they be offered to all employees on the same terms?
- Is there a maximum award value that can be granted under the plan, either on a per-company or per-employee basis?
- Are any tax/social security contributions payable when the award is made?

Phantom/cash-settled awards

Discretionary/all-employee. The awards can be made on a discretionary basis.

Maximum value of awards. There are no rules or regulations governing the maximum value of awards.

Tax/social security. There are no tax or social security implications at the time of granting the award.

16. In relation to the vesting of phantom or cash-settled awards:

- Can the awards be made to vest only where performance or time-based vesting conditions are met?
- Are any tax/social security contributions payable when these performance or time-based vesting conditions are met?

Phantom/cash-settled awards

Award vested only on conditions being met. Awards are typically linked to performance or time-based conditions.

Tax/social security. Tax or social security implications do not arise on vesting of the awards.

17. What are the tax and social security implications when the award is paid out?

Phantom/cash-settled awards

The employee must pay tax at the time of cash payout, which is treated as salary income. The employer is responsible for withholding these taxes and depositing them with the government within the applicable time frame.

INSTITUTIONAL, SHAREHOLDER, MARKET OR OTHER GUIDELINES

18. Are there any institutional, shareholder, market or other guidelines that apply to any of the above plans, and which types of companies are subject to them? What are their principal terms?

Besides the general laws, the specific laws governing ESOPs, ESPPs, sweat equity shares and other similar plans are as follows:

- SEBI ESOP Guidelines (applicable to listed companies and companies that are proposing to list).
- Unlisted Public Companies (Preferential Allotment) Rules, 2003 (applicable to unlisted companies).
- SEBI (Issue of Sweat Equity) Regulations, 2002 (applicable to listed companies).
- Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 (applicable to unlisted companies).
- Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 (applicable when an Indian company issues options or shares to employees abroad).
- Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 (applicable when a foreign company issues options/shares to an Indian employee).

EMPLOYEE REPRESENTATIVES

19. Is consultation or agreement with, or notification to, employee representative bodies required before an employee share plan can be launched?

In the absence of a collective bargaining agreement giving provisions for consultation, the labour laws do not require a company to consult or notify employee representative bodies before launching an employee share plan.

EXCHANGE CONTROL

20. Do exchange control regulations prevent employees sending money from your jurisdiction to another to purchase shares under an employee share plan?

An individual can remit funds for the purchase of shares of a foreign company under an ESOP irrespective of whether the shares are offered directly by the issuing company or indirectly through a trust, special purpose vehicle or step down subsidiary, provided certain conditions are met (see *Question 2*).

21. Do exchange control regulations permit employees to repatriate proceeds derived from selling shares in another jurisdiction?

Foreign companies can repurchase shares issued to Indian residents under an ESOP if the following conditions are met (*Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations 2004*):

- The shares are issued in accordance with FEMA.
- The shares are repurchased as specified under the terms of the plan.
- An annual return is submitted to the RBI through an authorised Indian bank, giving details of the remittances and beneficiaries.

The RBI requires an Indian resident to ensure that the proceeds derived from the sale of shares in another jurisdiction are repatriated not later than 90 days from the date of the sale.

INTERNATIONALLY MOBILE EMPLOYEES

22. What is the tax position when:

- An employee who is resident in your jurisdiction at the time of grant of a share plan award leaves your jurisdiction before any taxable event affecting the award takes place?
- An employee is sent to your jurisdiction holding share plan awards granted to him before he is resident in your jurisdiction?

Resident employee

An employee resident in India is taxed on his worldwide income. Therefore, the employee must pay tax at the time of exercise of

the share option on the difference between the fair market value on the date of exercise and the exercise price. The employer must withhold the applicable taxes and deposit them with the government within the applicable time frame. A merchant banker in India must issue a valuation report if the shares are unlisted in India or are of a foreign company.

Non-resident employee

A non-resident employee is taxed in India only to the extent that salary income is earned in India and the benefit relating to a period of employment in India during the vesting period is taxed in India. The benefit arising at the time of exercise of the option (the difference between the fair market value of the shares and the exercise price) is pro-rated over the vesting period depending on the number of days spent in India during this period.

A non-resident employee must pay capital gains tax in India if the shares are in an Indian company.

Indian law on the taxation of employee share options in the case of internationally mobile employees has received relatively little jurisprudence at this time, which may result in uncertainty in some circumstances.

PROSPECTUS REQUIREMENTS AND OTHER CONSENTS OR FILINGS

23. For the offer of and participation in an employee share plan:

- What prospectus requirements (if any) must be completed and by when? What exemptions (if any) are available?
- What other regulatory consents or filings (if any) must be completed and by when? What exemptions (if any) are available?

Prospectus requirements

There are no prospectus requirements for an Indian company granting options to its employees or employees of its subsidiary or holding companies. While there is no explicit exemption for foreign companies, it is unlikely that prospectus requirements would be triggered as the grants would be made to a close group of persons, such as employees.

Other regulatory consents or filings

In addition to making disclosures in the directors' report for the purposes of receiving shareholder approval (by special resolution in a general meeting), listed companies must make extensive disclosures to their shareholders in relation to ESOPs or ESPPs. Details of the disclosure requirements are given in the SEBI ESOP Guidelines.

Listed companies must also obtain an in-principle prior approval from the concerned share exchanges to list the shares on exercise and must notify the share exchanges when the options are exercised and shares issued. The formats for the approval and notification are given in the SEBI ESOP Guidelines. The listing of the shares must also comply with the provisions of the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009.



DEVELOPMENTS AND REFORM

24. Please briefly summarise:

- The main trends and developments relating to employee share plans over the last year.
- Any official proposals for reform of the law on employee share plans.

Trends and developments

Share options are yet to become an important component of employees' compensation structures in India. This is partly because promoters and entrepreneurs in traditional sectors often resist employees becoming shareholders.

Promoters and entrepreneurs are also concerned by the ESOP tax regime, which has seen a number of changes in the last several years. It is hoped that the new Direct Tax Code will introduce a stable tax regime for ESOPs and ESPPs, increasing their popularity.

Global mergers and acquisitions have resulted in issues such as the exchange of existing vested and unvested options with new options. In certain situations, foreign companies may also choose to substitute different options or make cash payments for under-water options in order to incentivise employees. Such exchanges or substitutions may lead to complex tax issues in India.

Reform proposals

There are no major proposals for reform of the law on employee share plans.

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Areas of practice. Employment and labour; employee benefits; employee share option plans; compensation structuring.

Recent transactions

- Represented GoAhead Software, Inc. in its acquisition of Avantellis from Emerson Network Power, which has operations in the US and in India.
- Advised MoSys Inc in its acquisition of the assets of Prism Circuits and its Indian subsidiary, Prism Circuits India.
- Advised Mars, Incorporated on its acquisition of the information technology division of Wm Wrigley Jr Company.

Areas of practice. Employee share option plans; compensation structuring; taxation of expatriates.

Recent transactions

- Advised several companies including Aricent, Autodesk, Bedford, NetAmbit, Taggle, Prism Circuits, Beceem, and Arcot Systems in relation to employee stock options matters and related Indian tax issues.

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