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India: Employee Share Plans in India: Regulatory Overview

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by [Stephen Mathias](#) (Bangalore) and [Ajay Prasad](#) (Bangalore)

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EMPLOYEE PARTICIPATION

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

It is quite common for employees of companies in certain industries (for example, information technology) to be offered employee share plans. It has also become quite common for start-up companies to offer share plans, regardless of the sector in which they operate. It is not common for manufacturing companies to offer share plans.

2. Can employees be offered a share plan where the shares to be acquired are in a foreign parent company?

A foreign company can offer share plans to both:

- Employees of its branch offices or subsidiaries in India.
- Employees of companies in India in which the foreign company holds shares. The shares can be held directly or through a special purpose vehicle.

In addition to employees, directors of an India office or subsidiary in which a foreign company holds shares can also be offered share plans.

Key conditions under exchange control laws are that:

- The parent company must offer the share plan globally on a uniform basis.
- The Indian company must submit an annual return to the Reserve Bank of India giving details of remittances, beneficiaries, and so on.

Additionally, any resident individual (whether or not the resident individual is an employee) can acquire shares issued by a foreign company under a cashless share plan programme, that is, the acquisition of shares does not involve the remittance of any foreign exchange.

SHARE OPTION PLANS

3. What types of share option plan are operated in your jurisdiction?

Share option plan

The most popular share option plan in India is a plan that grants employees options to purchase shares. Typically, the share option plan is structured in such a way that shares will vest in tranches, usually ranging between one to four years. The employee can exercise an option to purchase the shares once the shares vest.

The share options are non-transferable. They cannot be pledged, hypothecated, or encumbered in any way. A company can prescribe a mandatory lock-in period with respect to shares issued pursuant to exercise of the share option. The company can itself, or through an agent (for example, an empanelled stockbroker), fund the payment of the exercise price, which must be adjusted against the sale proceeds of some or all of the shares.

On termination of employment, the employee typically must exercise the vested options by the date of termination. Unvested options will generally be cancelled on termination of employment.

Share options remain the most popular form of share plans. They are offered by both listed companies (that is, companies whose shares are listed on a stock exchange in India) and unlisted companies. Different types of options can be granted under the same plan if the plan allows for it.

The minimum vesting period under company law is one year.

Indian law allows both listed and unlisted companies to implement share option plans through a trust. In the case of a listed company, the trust established must be an irrevocable trust. The company can lend money to the trust to purchase its shares but must comply with maximum lending limits set out in Indian company law.

In the case of a listed company, a trust structure must be set up if the operation of the plan involves the acquisition of shares in the secondary market. Securities regulations provide that a trust cannot purchase more than 2% of the company's paid-up equity share capital. The last available audited balance sheet of the company

will form the basis for this calculation. In addition, securities regulations prescribe individual thresholds for each type of share plan. There are also rules relating to the:

- Involvement of promoters in the board of trustees. This is a key corporate governance aspect of a trust.
- Categorisation of the trust's shareholding (that is, public, promoter or otherwise).
- Exercise of voting rights.

Grant

4. What rules apply to the grant of employee share option plans?

Share option plan

Discretionary/all-employee. Options can be granted on a discretionary basis. Options can be offered to some or all employees. The terms of the options can only differ if the plan allows for it.

The basic eligibility criterion for the granting of share options is that the individual must be a permanent employee of the company or of its holding or subsidiary company. The employee can work outside India. However, options cannot be offered to:

- Persons who are considered promoters of the company or who belong to the promoter group.
- Directors who, directly or indirectly, hold more than 10% of the outstanding equity shares of the company.

Recently, the government relaxed the application of these two restrictions with regard to start-up companies. Start-up companies can now grant share option plans to promoters and directors who hold more than 10% of the outstanding shares of the company, for a period of five years from the incorporation of the company.

Non-employee participation. A company cannot grant share options to:

- Independent directors.
- Consultants (unless the consultant is also a director or an employee who meets the eligibility criteria).

Maximum value of shares. The law does not prescribe any maximum value of shares in respect of which options can be granted, either on a per-company or per-employee basis. However, if during a given year, a company intends to issue options to identified employees that are equal to or exceed 1% of the company's issued capital at the time of the grant, it can only do so after obtaining shareholders' consent through a special resolution.

Market value. Under company law and securities law, a company can determine the exercise price that it deems fit, provided that the proposed exercise price complies

with the accounting standards issued by the accounting regulator. Most companies generally fix a price that is at least equal to the face value of a share. However, the securities regulations clarify that a company can re-price the options that are not exercised, regardless of whether they have vested, if the scheme was rendered unattractive due to a fall in price of the shares in the stock market.

5. What are the tax and social security implications of the grant of the option?

Share option plan

The grant of an option is not a taxable event under India's income tax law.

There are no social security implications arising on the grant of options.

Vesting

6. Can the company specify that the options are only exercisable if certain performance or time-based vesting conditions are met?

Share option plan

Companies can impose additional vesting conditions, such as the fulfilment of certain pre-determined performance metrics.

Under Indian law, when an employee dies or suffers permanent incapacity, all of their share options immediately vest in favour of their legal heirs or in favour of the employee who has suffered permanent incapacity, as the case may be.

7. What are the tax and social security implications when the performance or time-based vesting conditions are met?

Share option plan

The vesting of an option is not a taxable event under income tax law.

There are no social security implications on the vesting of options.

Exercise

8. What are the tax and social security implications of the exercise of the option?

Share option plan

The exercise of a vested option is a taxable event. The difference between the fair market value of the share and the exercise price of the option will be treated as income in the hands of the employee (in the "perquisites" category) and will be taxed as salary income. A foreign company or an unlisted company in India must have

obtained a valuation report from a licensed merchant banker at least six months before the exercise of the option by the employee.

The rate of tax depends on the employee's individual tax bracket. The maximum marginal rate of taxation for resident individuals in India is 30%. The company must deduct the taxes from the employee's salary and deposit the tax with the competent income tax officer within the applicable time frame.

There are no social security implications arising on the exercise of options, as this does not increase the employee's base salary or compensation for the purpose of calculating statutory benefits and pension rights.

Sale

9. What are the tax and social security implications when shares acquired on exercise of the option are sold?

Share option plan

The difference between the sale price and the fair market value of the share will be subject to capital gains tax. The rate of tax depends on the holding period of the shares (see below). Accordingly, there are two stages of taxation: on exercise and on sale. The cost of acquisition on the sale of shares is the fair market value of the shares at the time of exercise.

Sale of shares in a listed company. If the shares were held for more than one year, the gains arising from the transfer will be considered long-term capital gains (LTCG). If the sale is concluded on the floor of the stock exchange, no LTCG tax is payable. Instead, the government levies a nominal tax of 0.1% on the gross value of the sale transaction (called the securities transaction tax). The depository generally deducts this amount from the proceeds of sale and credits the balance to the client's account.

If the holding period of the shares is less than one year, the gains arising from the transfer are considered short-term capital gains (STCG). The rate of tax on STCG is 15%. The employee must disclose any STCG in his or her tax returns and pay income tax on them.

Sale of shares in an unlisted company. If the holding period of the shares is more than two years, the gains (if any) will be subject to LTCG tax at the rate of 20% for residents. The rate is 10% for non-residents, subject to the fulfilment of certain conditions.

If the holding period is less than two years, the tax rate is 30%.

The general rule is that surcharge and cess will be added to the tax rate. The buyer must withhold the tax if the seller is a non-resident and deposit it with the competent income tax department. The withholding tax obligation does not apply in the case of a resident individual.

SHARE ACQUISITION OR PURCHASE PLANS

10. What types of share acquisition or purchase plan are operated in your jurisdiction?

Share purchase plan

Under a share purchase plan, shares of the company are allotted upfront to an employee. The employee will immediately own the share, without reference to any vesting schedule. However, the employee cannot sell the shares until the expiry of a lock-in period. The lock-in period requirement does not apply where the shares are allotted to an employee both:

- As part of a public issue of shares.
- At the same price as it is offered to the public.

Generally, the rules that apply to share option plans also apply to share acquisition plans (see Questions 3 and 4).

Listed companies can implement share purchase plans. Company law does not regulate the operation of share purchase plans by unlisted companies, although they are permitted.

Share purchase plans are not as popular as share option plans. It is more common for Indian subsidiaries of foreign companies to operate share option plans.

Sweat equity shares

Both listed and unlisted companies can issue sweat equity shares. A listed company must comply with the relevant securities laws, while an unlisted company must comply with company law.

Sweat equity shares can be issued to an employee for contributing know-how, value additions or intellectual property rights to the company. A company that is at least one year old can issue sweat equity shares. Sweat equity shares can be allotted either for cash or for consideration other than cash. From a structural standpoint, sweat equity shares resemble share purchase plans. Shares are allotted upfront and without reference to any vesting schedule but are subject to a lock-in period of three years from the date of allotment. Under securities regulations, shares are subject to a lock-in period of one year only.

Sweat equity shares are not very popular among companies in view of the more stringent conditions for their issue in comparison to share option plans.

Acquisition or purchase

11. What rules apply to the initial acquisition or purchase of shares?

Share purchase plan

Discretionary/all-employee. See Question 4.

Non-employee participation. See Question 4.

Maximum value of shares. Securities laws do not prescribe any maximum value of shares that can be awarded under a share purchase plan, either on a per-employee basis or a per company basis.

Payment for shares and price. Generally, companies will require an employee to pay for the share purchase plans or sweat equity shares. A listed company can determine the price of shares, provided that it complies with the applicable accounting standards.

Sweat equity shares

Discretionary/all-employee. See Question 4. There are two key differences with respect to eligibility criteria under share option plans and sweat equity shares:

- The employee must be a permanent employee of the company for at least one year before the issuance of sweat equity shares.
- Promoters and persons belonging to the promoter group can be granted sweat equity shares, provided that they have been permanent employees of the company for at least one year.

Non-employee participation. See Question 4 and above.

Maximum value of shares. Under company law rules, an unlisted company cannot issue, in any given year, sweat equity shares that exceed the higher of:

- 15% of the existing company's existing paid-up equity share capital.
- Shares of the value of INR50 million.

In addition, the total number of sweat equity shares can never exceed 25% of the company's paid-up share capital at any point of time.

However, a company that is considered a "start-up", in terms of notification issued by the Central Government, can issue sweat equity shares that represent up to 50% of its paid-up capital for a period of five years from incorporation.

Payment for shares and price. The price of sweat equity shares to be allotted by a listed company must not 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 during the six months preceding the relevant date (that is, 30 days before the date on which the shareholders approved the resolution to issue sweat equity shares).

- 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.

The price must be supported by a report issued by a merchant banker, who must in turn obtain a valuation report from a chartered accountant that the company has complied with the applicable accounting standards in valuing the know-how or intellectual property.

The price of sweat equity shares to be allotted by an unlisted company must be determined on the basis of a report prepared by a practising-chartered accountant. In addition, a valuation of the intellectual property or know-how must be obtained. Sweat equity shares can be allotted at a discount or for consideration other than cash.

12. What are the tax and social security implications of the acquisition or purchase of shares?

Share purchase plan

If shares are allotted at a price that is less than their fair market value, the difference between the fair market value and the allotment price will be treated as perquisite income in the hands of the employee and included in their salary income. The rate of taxation depends on the employee's tax bracket. The rules on tax deduction are the same as for share option plans.

There are no social security implications on the issuance of share purchase plans or sweat equity shares, as this does not increase the base salary or compensation of employees for the purpose of calculating statutory benefits and pension rights.

Sweat equity shares

See above, Share purchase plan.

Vesting

13. Can the company award the shares subject to performance or time-based vesting conditions?

A company can award shares subject to performance or time-based conditions. Shares are typically awarded after performance criteria are met.

14. What are the tax and social security implications when the performance or time-based vesting conditions are met?

Share purchase plan

There are no tax implications on the fulfilment of vesting conditions.

There are no social security implications on the fulfilment of vesting conditions, as vesting does not increase the base salary or compensation of employees for the purpose of calculating statutory benefits and pension rights.

Sweat equity shares

See above, Share purchase plan.

Sale

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

Share purchase plan

See Question 9, Share option plan: Sale of shares in a listed company.

Sweat equity shares

See Question 9, Share option plan: Sale of shares in an unlisted company.

PHANTOM OR CASH-SETTLED SHARE PLANS

16. What types of phantoms or cash-settled share plan are operated in your jurisdiction?

Phantom or cash-settled share plans are popularly known as stock appreciation rights (SARs). Under a SAR, an employee is allotted a specified number of SAR units that are linked to the value of the company's shares on the date of allotment. On the relevant date, the employee will be paid a cash equivalent to the value of the shares to which the SAR units are linked.

A SAR is settled by way of either:

- Cash payment (cash-settled SAR).
- Allotment of an equivalent number of shares (equity-settled SAR).

Listed companies intending to set up a SAR must comply with securities regulations. SARs must have a minimum vesting period of one year. There is no lock-in period for shares allotted under an equity-settled SAR.

The rules relating to share option plans generally apply to SARs as well.

SARs are not very popular among companies. Unlisted companies rarely use SARs as an employee compensation tool. Cash-settled SARs are also less beneficial than stock options because the cash payment is taxed as regular income, which is higher than the rate of taxation on long-term capital gains on the sale of shares from stock options.

Grant

17. What rules apply to the grant of phantom or cash-settled awards?

Stock appreciation rights (SARs)

Discretionary/all-employee. See Question 4.

Non-employee participation. See Question 4.

Maximum value of shares. The securities regulations do not prescribe any maximum value of shares that can be awarded under SARs, either on a per-employee basis or a per company basis.

Payment for shares and price. SARs are not granted to employees against payment of any consideration but are offered as an incentive for performance. If an employee exercises equity-settled SARs, the value of the SARs is calculated, and an equivalent number of shares are allotted based on the current market price of the shares. If an employee exercises cash-linked SARs, the value of the SARs will be calculated on exercise and the trustee that manages the SARs will sell an equivalent number of shares on the stock exchange, and hand over the proceeds to the employee.

18. What are the tax and social security implications when the award is made?

Stock appreciation rights

There are no tax or social security implications when the award is made.

Vesting

19. Can phantom or cash-settled awards be made to vest only where performance or time-based vesting conditions are met?

Stock appreciation rights (SARs)

SARs can be structured in a way that they can only be exercised on the satisfaction of certain performance or time-based conditions. Since these schemes are not very popular among Indian companies, there is not enough data to comment on market practice.

20. What are the tax and social security implications when performance or time-based vesting conditions are met?

Stock appreciation rights (SARs)

There are no tax or social security implications when performance or time-based vesting conditions are met.

Payment

21. What are the tax and social security implications when the phantom or cash-settled award is paid out?

Stock appreciation rights (SARs)

The amount received by the employee will be treated as a perquisite and taxed as salary at the employee's individual income tax rate.

If an employee sells shares under equity-settled SARs, the difference between the allotment price and the sale price will be subject to capital gains tax. The rules on taxation are similar to those applicable to Question 9).

CORPORATE GOVERNANCE GUIDELINES, MARKET OR OTHER GUIDELINES

22. Are there any corporate governance guidelines, market rules or other guidelines that apply to any employee share plan?

A company intending to launch a share plan must obtain a special resolution approval from its shareholders. To do so, the company must send a notice and an explanatory statement to all shareholders, in which it must make a number of disclosures about the share plan regarding the following matters (among others):

- Eligibility criteria for employees.
- Exercise price.
- Vesting period.
- Exercise price formula.
- Lock-in period.
- Whether the company intends to establish a trust to implement the share plan.
- Methodology for valuing the options.

In addition to the above:

- A listed company must also list all the new shares created under a share plan. To do so, the company must obtain the approval from all the stock exchanges on which the company's shares are listed. Further, on exercise, the company must notify the stock exchange in accordance with the statement specified by the securities regulator.
- If the share plan is implemented through a trust structure, the company must comply with the various rules relating to the maintenance of proper books of account, appointment of trustees, eligibility criteria of trustees, disclosures by the trust, and so on.
- The trust must make disclosures and comply with other rules applicable to "insiders" or "promoters" under the various securities regulations.
- A listed company must set up a compensation committee under the applicable rules. This committee is responsible for administering the plan unless the company has set up a trust to implement the share plan, in which case the trust will implement the share plan.

- A listed company must place a certificate from the statutory auditor at every annual general meeting, which certifies that the company has complied with the securities regulations and the terms of the special resolution passed by the shareholders.
- A listed company implementing a sweat equity share plan must, within seven days of issue of sweat equity shares, disclose certain information to the stock exchange.

Additionally, a company that intends to offer employee share plans to non-residents must comply with the applicable exchange control laws. Generally, these rules have been considerably relaxed and only impose certain reporting requirements (see Questions 2 and 25).

EMPLOYMENT LAW

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

Under India's employment laws, consultation, or agreement with, or notification to, employee representative bodies is not required before an employee share plan can be launched.

24. Do participants in employee share plans have rights to compensation for loss of options or awards on termination of employment?

Indian law does not expressly provide for compensation for loss of options or awards on termination of employment. The standard practice is that, on termination of employment, all the unvested options or awards are automatically cancelled, regardless of the reason for termination. In such a scenario, an employee may also be required to exercise all of his or her unexercised vested options on or before the effective date of termination.

EXCHANGE CONTROL

25. How do exchange control regulations affect employees sending money from your jurisdiction to another to purchase shares under an employee share plan?

See Question 2. An employee intending to remit money abroad must approach an authorised dealer bank with a request on Form A2. The maximum amount that can be remitted in a given financial year is currently fixed at US\$250,000. To remit money abroad, an employee must have a permanent account number (PAN) issued by the income tax department. The law provides that banks need not require a PAN if the amount of remittance is less than US\$25,000. However, in practice, banks generally tend to insist on compliance with this requirement, regardless of the amount remitted.

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

An employee resident in India must immediately repatriate sale proceeds derived from selling foreign shares allotted under an employee share plan. The employee must repatriate the proceeds within 90 days from the date of the sale.

INTERNATIONALLY MOBILE EMPLOYEES

27. What is the tax position when an employee who is tax resident in your jurisdiction at the time of grant of a share option or award leaves your jurisdiction before any taxable event affecting the option or award takes place?

A resident is subject to income tax in India on their worldwide income. In the case of a share option or award, the exercise of the option and the sale of the shares are taxable events. If the employee is a resident at the time of this event, the employee will be subject to income tax, regardless of his or her actual presence in India (see Questions 8 and 9).

A person is a tax resident when they are either:

- Are present in India for at least 182 days during the relevant tax year (that is, 1 April to 31 March).
- Have, within the four years preceding the relevant tax year been in India for a period or periods amounting to 365 days or more and have been in India for a period or periods amounting to 60 days or more in that year.

Non-resident employee

28. What is the tax position when an employee becomes tax resident in your jurisdiction while holding share options or awards granted abroad and a taxable event occurs?

The general rule is that salary and perquisites (such as share options) are taxable in India if they are earned in India. While the grant of share options is not a taxable event, the exercise of share options and a subsequent sale of shares are taxable events.

Income earned by a non-resident on exercise of share option is pro-rated over the vesting schedule between his or her stay in India and outside India. However, there are no clear rules on this issue.

If the employee sells shares of a company in India, he or she will be subject to income tax in India under the category of capital gains (see Question 9).

SECURITIES LAWS

29. What are the requirements under securities laws or regulations for the offer of and participation in an employee share plan?

In listed companies, shares allotted under an employee share plan must be listed on the recognised stock exchange on which the other company's shares are listed. This requires the approval of the relevant stock exchange. On the exercise of the options, the company must notify the stock exchange in the prescribed form. A listed company that sets up an employee share plan must disclose its decision to the stock exchange.

30. Are there any exemptions from securities laws or regulations for employee share plans? If so, what are the conditions for the exemption(s) to apply?

There are no exemptions from securities laws for employee share plans.

OTHER REGULATORY CONSENTS OR FILINGS

31. Are there any other regulatory consents and filing requirements and/or other administrative obligations for an offer of and participation in an employee share plan?

The resolution of the company's shareholders that approves the launch of an employee share plan must be filed with the company registry. In addition, when a company issues shares following the exercise of an option, this must be reported to the company registry by filing prescribed forms.

A company must also report the grant of share plans to non-residents to the Reserve Bank of India.

The company must make entries in certain statutory registers maintained with respect to share plans, such as the register of sweat equity shares, the register of employee share option plans, and so on.

The board's report must contain details of the various share plans implemented by the company in each financial year.

32. Are there any data protection requirements or obligations for an offer of and participation in an employee share plan?

It is likely that some employee information processed by the employer will be financial information, which qualifies as sensitive personal data or information. To obtain or transfer sensitive personal data or information, the employer can either:

- Obtain the employee to agree to the employer's own security standards and privacy policy.
- Comply with Indian privacy rules, which require the employer to obtain the employee's consent.

FORMALITIES

33. What are the applicable legal formalities?

Translation requirements

There is no legal requirement to translate plan documents into the local languages.

E-mail or online agreements

An employee can enter into electronic binding agreements to participate in employee share plans.

Witnesses/notarisation requirements

To be binding, agreements related to employee share plans need not be notarised, witnessed, or registered.

Employee consent

The employee's consent is not required for the actions required to administer his or her options or other awards. See Question 32 for information on data protection requirements.

DEVELOPMENTS AND REFORM

34. Are there any current trends, developments and reform proposals that have or will affect the operation of employee share plans?

Trends and developments

With India witnessing a start-up boom, options are being increasingly used by companies to attract and retain talent.

Reform proposals

The authors are not aware of any proposal or change that will affect the regulatory framework governing employee share plans.

ONLINE RESOURCES

Securities and Exchange Board of India (SEBI)

W http://www.sebi.gov.in/cms//sebi_data/Regulations.html

Description. This is the official website of SEBI, which is India's market regulator. The website is generally maintained and up to date and contains all the regulations referred to in this Q&A in relation to listed companies.

Reserve Bank of India (RBI)

W <http://www.rbi.org.in/scripts/Fema.aspx>

Description. This is the official website of the RBI, which is India's central bank. The website is generally maintained and up to date and contains all the regulations referred to in this Q&A in relation to exchange control laws.

Ministry of Corporate Affairs

W <http://www.mca.gov.in/MinistryV2/companiesact2013.html>

Description. This is the official website of the Ministry of Corporate Affairs, which, through its various officers, is responsible for implementing company law. The website is generally maintained and up to date, and contains all the laws referred to in this Q&A.

Income Tax Department

W <http://www.incometaxindia.gov.in/Pages/default.aspx>

Description. This is the official website of the Income Tax Department, which, through its various officers, is responsible for implementing income tax law. The website is generally maintained and up to date, and contains all the laws referred to in this Q&A.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

AUTHOR(S)



Stephen Mathias
Kochhar & Co.



Ajay G. Prasad
Kochhar & Co.

