

Taxation of Stock Options in India

Employees in India

Given the dynamic and competitive market in India in recent years, US employers have sought to attract highly educated and experienced talent with robust compensation packages and benefits that encourage loyalty and commitment to the company's long term success in India. This has typically included offering stock options or similar equity based compensation to employees in India. As most US companies will create a local subsidiary in India to employ local staff, the overall compensation package will often include salary and local benefits provided by the Indian subsidiary, coupled with stock option or equity benefits from the US parent company.

Local laws and India's annual budget process have an effect on the tax treatment and tax rates that apply to employment salaries and benefits and, specifically, the tax treatment of stock options and equity incentives awarded to Indian employees by US parent companies.

The Indian Finance Bill 2009 entered into law last month, with retroactive effect. With it came an updated regime for the tax treatment of employee stock options.

Prior law: Fringe Benefits Tax—tax calculated based on value at vesting

For the last few years, employee stock options held by India residents have been subject to a Fringe Benefits Tax ("FBT") at the time of exercise, and a capital gains tax at the time of share disposition. FBT was payable by employers (generally the local

Indian subsidiary) and, in some instances, could be recovered from the employee exercising the option. However, even if FBT was recoverable from exercising employees, the US parent company or its subsidiary was forced to incur significant costs associated with determining the amount of the taxable gain associated with the exercise—and therefore the amount of tax payable. Unlike Non-Statutory Options in the United States, the taxable gain on the exercise of a stock option was not the difference between the fair market value of the purchased stock at the time of exercise and the exercise price. Instead, the taxable gain was the difference between the fair market value of the purchased stock at the time of *vesting* and the exercise price. Assuming a typical stock option had a four year vesting schedule (1 year cliff, then monthly vesting over the following 3 years), this could require up to 37 different tax calculations for each stock option. Needless to say, the spreadsheets tracking these gains could become very complicated.

Further, in order to determine the fair market value of the underlying stock to complete these calculations, an issuer was required to obtain a valuation from an Indian merchant (investment) banker. Also, the FBT payment schedule was not designed to reflect the practical realities of stock option exercises. FBT was payable quarterly but the required quarterly allocation was difficult to compute without having clear visibility on the magnitude of anticipated option exercises over the course of the entire year. Finally, there was additional uncertainty with respect to the FBT

rules when employees "early exercised" their options.

New law: income tax on exercise—tax calculated based on value at exercise

Under the new tax law, the Indian legislature appears to have rectified one of the burdensome aspects of the FBT regime: the mismatch between the time of measurement of taxable option gain for FBT purposes and time of option exercise. Under the new tax law, the taxable gain that is measured at the time of exercise is based on the fair market value of the option stock at exercise. Local tax professionals have indicated that this taxable gain on exercise is calculated as the difference between the fair market value of the option stock at the time of *exercise* and the option exercise price (i.e., similar to the gain calculation when exercising a US Non-Statutory Option). In an additional change from the FBT rules, this amount is taxable to an Indian resident employee as a "perquisite" and subject to withholding.

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The additional gain upon disposition of the underlying shares would still be subject to capital gains tax. While this is good news that there will no longer be a need for elaborate spreadsheets tracking the possible gain at each vesting date for each stock option and that employers can more easily and clearly withhold the tax from the employee's own wages, it is not yet clear whether issuers will still be required to obtain valuations from an Indian merchant bank in order to determine the fair market value of the purchased shares at the time of exercise.

Unanswered questions

We expect these and other details to be included in forthcoming regulations to be issued by the Indian tax authorities shortly. Open questions regarding this new tax regime include:

- (1) the required methodology, if any, for calculating the fair market value of the underlying stock at exercise;
- (2) whether other forms of equity incentives (RSUs, restricted stock subject to vesting, etc.) will be included in this regime, and how the rules will be applied to such instruments;
- (3) whether there will be special rules for early exercising options;
- (4) whether there will be any special guidelines adopted to provide exceptions to these rules (similar to the guidelines adopted by the Finance Ministry in 2001 under a prior tax regime); and
- (5) how to recover FBT paid under the 'old' regime, given that the new rules have retroactive effect.

We will issue additional Cross-Border Commentaries as further regulations are issued and these questions answered.

Practical considerations

Given that the new tax regime has been adopted but the underlying regulations

have not been enacted, uncertainty remains. However, there are a few actions companies with Indian resident employees holding stock options could consider taking in the interim:

- ▶ Review your current equity incentive plan documentation and form of grant package to determine whether updates are needed (particularly in any description of Indian tax rules).
- ▶ Advise your Indian accountant/payroll service/tax advisor of any exercises so that withholding can be implemented properly.
- ▶ Advise your Indian accountant/payroll service/tax advisor if FBT has been paid on options exercised after March 31, 2009 to determine possible refund alternatives and whether any remedial action should be taken for failure to withhold income tax on options exercised during that period. ■

We gratefully acknowledge the assistance of several top legal advisers in India for their guidance and input on the issues summarized in this Cross Border Commentary and for enabling us to make this information available. Neither Cooley Godward Kronish LLP nor its members are qualified to practice law in India.

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