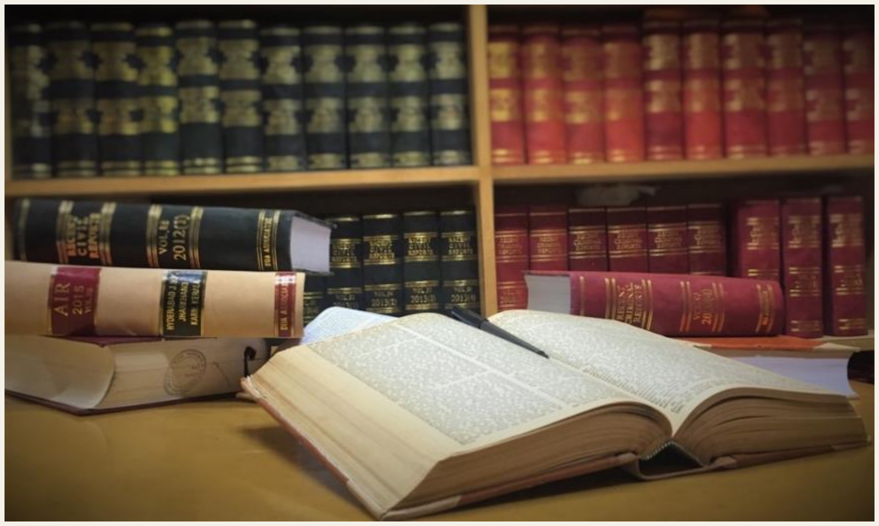

An Analysis of the Legal Framework in India on Issue of ESOP/Sweat Equity by a Foreign Parent to Employees of its Indian Subsidiaries

I. ESOPs and Sweat Equity

Employee Stock Option Plan **(“ESOPs”)** or sweat equity shares are an attractive option relied upon by companies looking to retain and incentivize employees. In the recent times and especially with start-ups picking up pace, these are being increasingly used by foreign companies and start-ups located outside India to reward employees of Indian subsidiary companies. In this article, we will examine the regulatory framework governing issue of ESOPs/sweat equity shares by a foreign parent to employees of its Indian subsidiaries and aspects related to the transfer of shares acquired by the employees by way of ESOPs/sweat equity.

In terms of the Companies Act, 2013 **("CA 2013”),** an Employee Stock Option Plan is an option given to the Directors, officers or employees of a company, or of its holding company or of its subsidiary company or companies, if any, which gives such Directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

Further, the CA 2013 defines sweat equity shares to mean equity shares issued by a company to its directors or employees at a discount or for consideration other than cash, for providing their know-how or making available rights, in the nature of intellectual property rights or value additions, by whatever name called.

II. Implications under Foreign Exchange Management Act,1999 ("FEMA") on ESOPs/Sweat Equity

The acquisition, by persons resident in India, of ESOPs offered by a foreign entity is governed by the regulations framed under FEMA. Prior to August 22, 2022, the issue of equity shares/ESOPs by a foreign parent entity to the employees of its Indian subsidiaries were governed by the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 framed under FEMA (“Erstwhile OI Regulations”).

Under the "general permission" in terms of the Erstwhile OI Regulations, a resident individual was allowed to acquire foreign securities issued by a company incorporated outside India under Cashless Employee Stock Option Scheme provided it did not involve any remittance from India. A resident individual was also allowed to purchase equity shares offered by a foreign company under its ESOP Schemes provided that the shares under the ESOP Scheme were offered by the issuing company globally on a uniform basis. While there was no specific reporting requirement to the Reserve Bank of India **(“RBI”)** by the Indian entity or the resident individual for cashless ESOPs, an annual return was required to be submitted by the Indian company to the RBI through the Authorized Dealer Bank **("AD Bank")** giving details of remittances / beneficiaries, etc. in case of purchase of equity shares under ESOP Scheme.

A person resident in India was allowed to transfer by way of sale the shares acquired as stated above provided that the proceeds thereof were repatriated immediately on receipt thereof and in any case not later than ninety (90) days from the date of sale of such securities.

New Regime

On August 22, 2022, the Foreign Exchange Management (Overseas Investment) Rules, 2022 **(OI Rules),** Foreign Exchange Management (Overseas Investment) Regulations, 2022 **(OI Regulations)** read with Master Direction on Foreign Exchange Management (Overseas Investment) Directions, 2022 issued under FEMA came into effect (collectively the “**New OI Regulations”**), post which any issue and/or sale of foreign securities is governed by the New OI Regulations.

Some of the key highlights of the New OI Regulations are as follows:

- A resident individual may make Overseas Direct Investment ("ODI") by way of investment in equity capital or Overseas Portfolio Investment ("OPI").

- An acquisition of less than ten per cent of the equity capital, of a listed or unlisted foreign entity, without control, including by way of acquisition of sweat equity shares or interest under ESOP or Employee Benefit Scheme (EBS) is classified and treated as OPI for the purposes of OI Rules.

- A resident individual, who is an employee or a director of an office in India or branch of an overseas entity (liaison office or branch office) or a subsidiary in India of an overseas entity or of an Indian entity in which the overseas entity has direct or indirect equity holding, is allowed under the OI Rules to acquire, without limit, shares or interest under (i) ESOP or (ii) EBS or (iii) sweat equity shares offered by such overseas entity.

- In respect of EBS or ESOP, it is specified that these are required to be offered by the issuing overseas entity globally on a uniform basis, however, no such requirement has been specified for sweat equity shares.

- In case of OPI, by way of acquisition of shares or interest under ESOPs or EBS, the concerned Indian subsidiary/entity is required to submit half yearly reports in Form OPI to the RBI through its AD Bank. The half-yearly reports due for the periods ending March 31 and September 30 must be submitted within sixty (60) days of the end of such reporting period.

Key Changes Under The New Regime

- The distinction between cashless ESOPs and ESOPs acquired by way of investment has been done away with and now the Indian entity is required to adhere to the reporting requirements in respect of cashless ESOPs as well.

- Sweat equity shares have been clearly provided for, distinct from ESOP or EBS and there is no requirement for these to be offered globally on a uniform basis.

- The acquisition of shares or interest, less than ten percent of the equity capital and without control, under ESOPs/EBS or sweat equity shares have been clearly categorized as OPI.

- Under the Erstwhile OI Regulations, Form ESOP was an event-based reporting, however, the reporting in Form OPI is a time-bound requirement under the New OI Regulations irrespective of whether ESOPs have been issued during such period.

Conditions Relating to Transfer

- As per the OI Rules, a person resident in India holding equity capital in accordance with these rules may transfer such investment, in compliance with the limits, applicable conditions for such investment or disinvestment, pricing guidelines, documentation and reporting requirements, prescribed by the OI Rules and OI Regulations.

- Transfer of such equity capital by way of sale to a person resident outside India is permitted.

- Transfer on account of merger, amalgamation or buyback of foreign securities, requires approval of the competent authority as per the applicable laws in India or the laws of the host country or host jurisdiction, as the case may be.

- The obligation for reporting in case of transfer of shares or interest acquired under ESOPs or EBS is also on the Indian subsidiary/entity and not on the individual employee.

Payment Of Sale Proceeds/Consideration For Transfer Of Shares Of Indian Employees

- All dues receivable on investments (or financial commitment) made in freely convertible currencies and their sale proceeds are required to be repatriated to India in freely convertible currencies only. Accordingly, the consideration for the transfer of shares issued to the employees pursuant to an ESOP scheme or sweat equity shares, shall be paid directly by the overseas buyer in compliance with the requirements under the New OI Regulations.

- The OI Regulations provide inter-alia that a person resident in India having ODI in a foreign entity, shall realize and repatriate to India, the amount of consideration received on account of transfer or disinvestment of such ODI within ninety days from the date of such transfer. There is no such requirement in respect of amount of consideration received on account of transfer or disinvestment of OPI held by a resident individual under the OI Regulations. However, in terms of the Liberalized Remittance Scheme of the RBI ("LRS"), an investor who has remitted funds under LRS can retain, reinvest the income earned on the investments.

  Further, the LRS provides that received/realized/unspent/unused foreign exchange, unless reinvested, shall be repatriated and surrendered to an authorized person within a period of 180 days from the date of such receipt/ realization/ purchase/ acquisition or date of return to India, as the case may be, in accordance with Regulation 7 of Foreign Exchange Management (Realization, repatriation and surrender of foreign exchange) Regulations, 2015. Accordingly, in case of remittance having been made by employees for acquisition of shares under ESOP, the aforesaid timeline would be relevant.

III. Taxation of ESOP/Sweat Equity Shares

Consumer Protection – Real Estate disputes – Compensation – Award Compound Interest[14]

In case of ESOPs/sweat equity shares, the taxable event occurs at two stages:

First Stage

When shares are allotted (in case of ESOPs, upon the employee exercising his option on completion of the vesting period):

- Section 17(2)(vi) of the Income-tax Act, 1961 ("IT Act") inter-alia states that any specified security (including ESOPs granted under a scheme or a plan) or sweat equity shares allotted or transferred, directly or indirectly, by employer, free of cost or at a concessional rate shall be treated as a 'Perquisite' and be taxed accordingly under the IT Act.

- Explanation (c) to Section 17(2)(v) further provides that the value of any specified security shall be the fair market value of the specified security on the date on which the option is exercised by the assessee as reduced by the amount actually paid by, or recovered from, the assessee in respect of such security or shares.

- The perquisites arising under ESOP scheme/sweat equity shares are taxable in the hands of the employees in the year in which shares are allotted to the employees and nothing is taxable when the shares are just vested but not allotted. Accordingly, upon allotment of shares pursuant to exercise of the option by an employee i.e. the first stage, the difference between the exercise price and the fair market value of the shares would be treated as 'Perquisite' in the hands of the employee and the employer would be required to deduct tax at source on such difference.

Second Stage

When the employee opts to sell the allotted shares:

- At the time of sale of the allotted shares , the provisions of Section 45 of the IT Act become relevant which inter-alia provides that any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections specified therein, be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.

- One must therefore further evaluate whether it qualifies as a short-term capital asset as envisaged under sub-section (42A) of Section 2 of the IT Act or a long-term capital asset as envisaged under sub-section (29AA) of Section 2 of the IT Act, to determine the taxability as long-term or short-term capital gains.

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