




Operating Employee Share Plans in India, Hong Kong and China

by
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Case Study on Wipro Equity Programs

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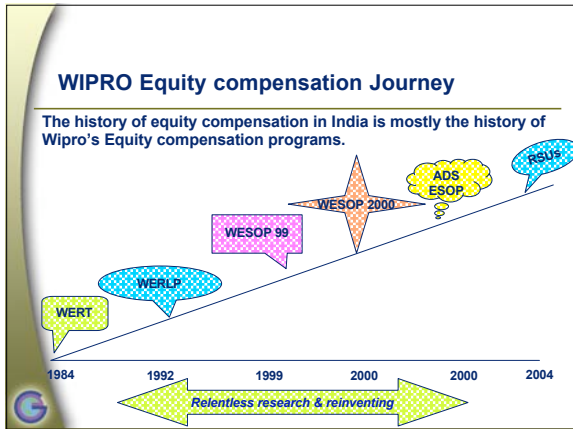
WIPRO – Global presence with local face

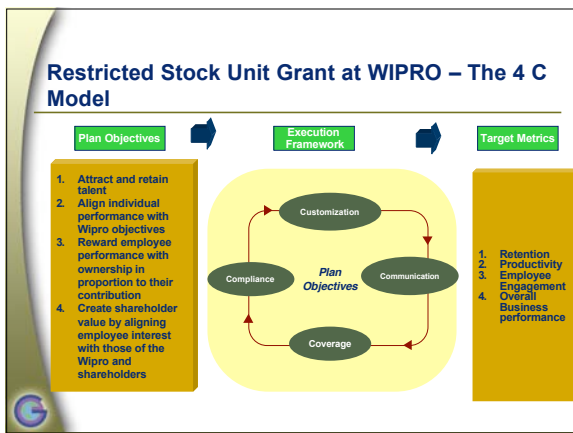


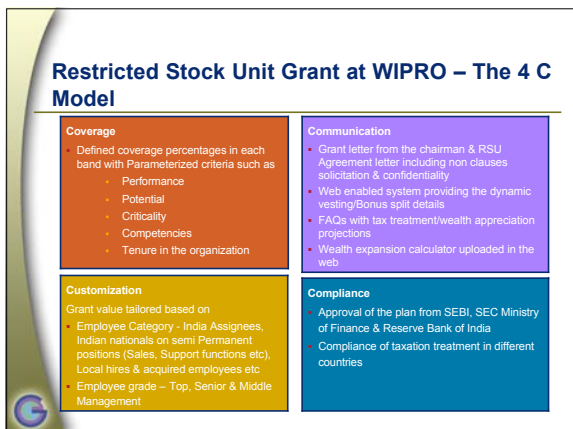
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Restricted Stock Unit Grant – The WIPRO experience

- * The operating Margin of the company improved from 21.9% in 2003-04 to 26.4% in 2004-05 with higher managerial engagement
- * The attrition rate among RSU awardees was 5.7% as against the company average attrition of 13.6% in 2004-05



Indian Scenario

- * Absence of equity culture til leading IT companies like "Wipro" started granting stocks/options in 1980's
- * The first SEBI guidelines on broad- based stock options were issued in 1999
- * With IT industry slowdown, the options went underwater and the employees lost interest in stock option programs
- * On introduction of stock option expensing, the companies became conservative on granting fresh options
- * With IT industry growth and more outsourcing from India, the pressure for retention increasing
- * The companies are increasingly depending on cash compensation & stock grants for retention of key talent
- * Currently a fairly stabilized accounting treatment of stock options is practised (uniform intrinsic value based expensing is followed by companies)



India – Regulatory Framework on Share Plans

- * Securities Exchange Board of India (SEBI) Rules
- * Exchange Control (Reserve Bank of India) Rules
- * Income Tax (Government of India) Rules
- * Challenges of Indian multinational companies to simultaneously comply with international regulations - SEC, FASB, IRC Rules etc



India – SEBI Regulations

- * Securities Exchange Board of India (SEBI) lays down detailed rules for design & administration of stock options covering the below clauses et al:
 - ❖ shareholder and C&B Committee of the Board approval
 - ❖ lock in period & rights of an option holder
 - ❖ rights & duties of compensation committee
 - ❖ non-transferability of options
 - ❖ accounting policies



India – RBI Regulations

- * RBI stipulates that all regulations laid down by SEBI are followed by the company and in addition stipulates that no NRI (Non Resident Indian) is granted Options which is more than 5% of the Capital (Outstanding floating shares)
- * In case of employees of Indian companies placed outside India, they have to deposit forex money worth the value of exercise price in order to expatriate the options in their names
 - ❖ e. g. if 500 WESOPs worth exercise price of Rs. 1000 are to be repatriated the employee has to bring Rs. 500,000 to India in order to get the options
- * Indian employees who have the benefit of ESOP schemes in foreign owned companies can now invest up to US\$ 20,000 per annum. Earlier this facility was available only to the extent of US\$ 10,000 in a block of five years



India – Income Tax Regulations

- * Stock option plan of the Company has to be filed with the Chief Commissioner of Income tax within 6 months of shareholder approval
- * If the scheme does not meet with the RBI/SEBI guidelines, then taxability shall be at two levels:
 - ❖ level 1 at the time of exercise – as salary income
 - ❖ level 2 at the time of sale – as capital gains
- * For a SEBI/RBI compliant stock options plan, the taxability shall be:
 - ❖ if option converted shares were held for a period less than or equal to 12 months from the allotment date, 10% tax will apply on the gains realized (Short-term capital gains tax)
 - ❖ if option converted shares were held for a period more than 12 months from the allotment date, 0% tax will apply on the gains realized (Long-term capital gains tax)



Ongoing Regulatory Changes in India

- Naresh Chandra committee (2003) on corporate governance has recommended greater disclosure requirements for executive & directors remuneration
- ICAI issued a guidance note in Q1 2005-06 & is in the process issuing a final accounting standard in compliance with IFRS (International Financial Reporting Standard) on stock options expensing in India
- Tax legislation and exchange control regulation is being smoothened from time to time. As a progressive move, in Oct 2004, Govt of India introduced Securities Transaction tax at 0.075% on the volume of transaction (buying or selling) & consequently reduced the tax on Short-term & Long-term capital gains (from 30% and 10% to 10% & 0% respectively) – boosting the capital market participation



End of Section on India





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HK – Overseas Incentive Plans (1)

- * Typical scenario: Overseas listed parent company wishing to allow certain employees in subsidiary/branch in HK to participate in an offshore incentive plan
- * General comment: no specific HK restrictions on form of incentive plan
- * Issue to consider is whether the plan constitutes an “offer to the public of securities”? If so, the offer must be in the form of a registered prospectus unless an exemption is available



HK – Overseas Incentive Plans (2)

Possible Exemptions:

- * “Domestic concern”:
 - ❖ i.e. existing special relationship between offeror (overseas company) and offerees (employees);
 - ❖ the number of offerees; and
 - ❖ the nature and content of the offer
- * Most (but not all) incentive plans can be viewed as being a domestic concern



HK – Overseas Incentive Plans (3)

- * Exemptions pursuant to recent amendments to Companies Ordinance (3rd Dec., 2004)
 - ❖ offer to “qualifying persons” of the company or of another group company
 - “qualifying persons” include a bona fide current and former directors, employees and consultants of the company and their respective dependants
 - ❖ offer to not more than 50 persons in HK
 - ❖ offer of which the total consideration payable by all HK participants does not exceed HK\$5,000,000



HK – Overseas Incentive Plans (4)

- * No exchange control
- * No general restriction over share ownership (some exceptions)
- * No obligation to consult trade unions/employees before implementation of incentive plans



HK – Overseas Incentive Plans (5)

- * Deduction from salary
 - ❖ common practice in many jurisdiction when operating incentive plans but is not possible under HK law. Commissioner of Labour unofficially declined to grant exemption
 - ❖ alternative practice of having employee give written instructions to employer to split salary payment and deposit the requisite amount (for participation in incentive plan) into a separate designated account can be considered
- * Incentive plan should not take the form of a retirement scheme



HK – Trend on Incentives

- * HK listed companies –
 - ❖ share Option Scheme still most commonly used; with some companies adding restricted share plans
- * Overseas/International corporations –
 - ❖ more variety of incentive plans used. Companies often have more than one type of incentive plan in place and different plans may operate at different levels
 - ❖ general trend moving from share option plans towards restricted share plans and/or phantom share plans



PRC – Regulatory Restrictions – Shares of Domestic Companies (1)

- * No treasury stock allowed
- * Repurchased stock should be cancelled to reduce registered capital
- * Change of registered capital requires registration and re-issuance of business license



PRC – Regulatory Restrictions – Shares of Domestic Companies (2)

- * Time consuming CSRC approval procedures on issuance of new shares by listed companies
- * Executives may not transfer shares of the company during their office tenure



PRC – Regulatory Restrictions – Shares of Foreign Entities (1)

- * Securities law uncertainties on offering of foreign securities
 - ❖ no specific provisions under the Securities Law on offering of foreign stocks to PRC nationals
 - ❖ CSRC's position not clear
 - ❖ no procedures to approve or disapprove such arrangement



PRC – Regulatory Restrictions – Shares of Foreign Entities (2)

- * Foreign exchange requirements
 - ❖ stock options to PRC national employees may be regarded as settling domestic obligations in foreign exchange
 - ❖ purchase of foreign stocks by PRC nationals generally requires special approvals which are not available in practice



PRC – Regulatory Restrictions – Shares of Foreign Entities (3)

- * Open issues
 - ❖ will stock options be considered in calculating severance pay when the relevant employees are terminated?
 - ❖ can the PRC employer deduct the cost of options from the employees' salary? Will such deduction be respected for tax purposes?



Market Practice – Offshore Trust Structure (1)

- * Offshore trust documentation
- * PRC national employees as the beneficiaries
- * Employees hold no legal title to the foreign stocks
- * Stocks can be held by the offshore trustee in favor of the PRC beneficiaries



Market Practice – Offshore Trust Structure (2)

- * Advantages:
 - ❖ more equity feature and sense of ownership to employees
 - ❖ possible favorable capital tax treatment
- * Disadvantages:
 - ❖ uncertainties regarding the recognition of foreign trust involving PRC elements
 - ❖ funding required to purchase foreign stocks



PRC – Future Regulatory Changes

- * Foreign exchange de-regulation
- * Securities law clarifications
- * Trust law developments



PRC – Market Practice – Offshore Trust Structure

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PRC – Future Regulatory Changes

- * Foreign exchange de-regulation
- * Securities law clarifications



HK – Share Option Plans – Tax (1)

- * On option grant? NO
- * On option becoming exercisable? NO, but
 - ❖ employees ceasing employment and leaving HK permanently may make a "deemed exercise" election (i.e. taxed as if option exercised on departure)
 - ❖ no further tax on exercise after departure; refund may be granted if tax overpaid
- * On option exercise? YES
 - ❖ salaries tax on "spread" (i.e. excess of market value of shares at exercise over exercise price)
- * On disposal of shares? NO



HK – Share Option Plans – Tax (2)

HKIRD's Departmental Interpretation & Practice Notes No. 38 (March 2005) (replace 2001 notes)

- * "Deemed exercise" provisions
 - ❖ deemed exercise" date ("DED") may be any date within 7-day period preceding final tax return submission date
 - ❖ election may be made within 3-month period from departure – departure date is then the DED
- * Source of share option gain
 - ❖ gain chargeable to HK tax if "income arising in or derived from" HK
 - ❖ likely to apply: (i) if HK employment at time of grant; (ii) if non-HK employment, where services performed in HK pre-grant or pre-vesting



HK – Share Plans – Tax

Taxable event	Restricted Share Plans	Conditional Share/RSU Plans
Award?	YES , generally. BUT * check nature of participant's rights * confirm position in advance with HKIR Taxable amount is market value of shares at award	NO
Vesting?	NO generally (unless not taxed on award)	YES - Taxable amount is market value of shares at date conditions are satisfied and shares are transferred
Disposal?	NO	NO

Note: HKIRD has promised separate Practice Note on share awards

HK – Tax

- * Income tax ("salaries tax") – graduated rates, subject to maximum flat rate of 16% (2005/2006)
- * Social security \Rightarrow **NO** – mandatory Eer/Eee contribution of 5% of "relevant income" to MPF (subject to cap), but excludes non-monetary benefits
- * **NO** withholding, except on Eee ceasing employment and leaving HK permanently
- * Employer reporting obligations at start, during, and on cessation of employment
- * Corporation tax deduction \Rightarrow generally **YES** – if local Eer bears the costs
- * Tax planning \Rightarrow **NO** tax-approved plans, **but** (i) relatively low tax rates, and (ii) no capital gains tax, may make share-based benefits attractive

PRC – Background – Tax

- * Share option/share plans relatively new in \Rightarrow PRC not specifically addressed by tax/social security laws
- * PRC tax authorities
 - ❖ have considerable discretion to interpret tax questions
 - ❖ practice is to resolve these on a case-by-case basis and seek detailed information on each plan
- * Advisable to consult relevant authorities if tax implications unclear

PRC – Share Option Plans – Tax

- * On option grant? → NO
- * On option becoming exercisable? → NO
- * On option exercise? → YES
 - ❖ income tax/social charges on "spread" (i.e. excess of market value of shares at exercise over exercise price)
 - ❖ **but** expatriate who has lived in PRC < 5 years, taxed only on part of benefits relating to services in PRC
- * On disposal of shares? → YES, gains generally taxed as income, **but**
 - ❖ gains exempt from sale of (i) shares listed in PRC (ii) shares of Chinese company listed abroad
 - ❖ gains exempt for expatriates who have lived in PRC < 5 years



PRC – Share Option Plans – Tax

Taxable event	Restricted Share Plans	Conditional Share/RSU Plans
Award?	DEPENDS * tax likely to be deferred until restrictions lapse (i.e. vesting) * confirm position in advance with PRC authorities	NO
Vesting?	YES , generally (assuming not taxed on award) Taxable amount (also subject to social charges) is market value of shares at vesting	YES – taxable amount (also subject to social charges) is market value of shares at vesting
Disposal?	YES – gains taxed as income (unless exemption applies)	YES – gains taxed as income (unless exemption applies)



PRC – General – Tax (1)

- * Income tax – due on a monthly basis at progressive rates from 5% to 45% (2005/2006)
- * Share sale gains taxed as "asset transfer" income – flat rate of 20% (2005/2006)
- * Social security – Eer/Eee contributions to social insurance funds at different provincial rates
- * Tax/social charge withholding required (likely position even if local Eer does not bear costs, but confirm this with PRC authorities)



PRC – General – Tax (2)

- * Employer tax reporting on monthly basis; social security reporting under relevant provincial rules
- * Corporation tax deduction ⇔ DEPENDS – probably available if local Eer bears the costs (as concept of "deductible expenses" is unclear, confirm position with PRC authorities)
- * Tax planning ⇔ NO tax-approved plans, **but** Eee may defer tax payment on option gains with approval of PRC authorities



End of Section on Hong Kong and China



Questions?

Thank you for your participation




Appendix 1
Details on Indian Regulatory framework
 (Bijay Sahoo)

Appendix 2
Recent Developments Elsewhere in Asia
 (Sylvie Watts)



India – SEBI Regulations on ESOS (Employee Stock Option Schemes): Eligibility to participate

- * An employee who is a promoter or belongs to the promoter group shall not be eligible to participate in the ESOS
- * A director who either by himself or through his relative or through any body corporate, directly or indirectly holds more than 10% of the outstanding equity shares of the company shall not be eligible to participate in the ESOS



India – SEBI Regulations on ESOS: Shareholder approval

- * No ESOS can be offered to employees of a company unless the shareholders of the company approve ESOS by passing a special resolution in the general meeting after the approval of C&B committee
- * The resolution proposed to be passed in general meeting shall include the below:
 - ❖ the total number of options to be granted;
 - ❖ identification of classes of employees entitled to participate in the ESOS;
 - ❖ requirements of vesting and period of vesting;
 - ❖ maximum period within which the options shall be vested;
 - ❖ exercise price or pricing formula;
 - ❖ exercise period and process of exercise;
 - ❖ the appraisal process for determining the eligibility of employees to the ESOS;
 - ❖ maximum number of options to be issued per employee and in aggregate



India – SEBI Regulations on ESOS: Lock-in period and rights of the option-holder

- * There shall be a minimum period of one year between the grant of options and vesting of option
- * The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option
- * The employee shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to him, till shares are issued on exercise of option



India – SEBI Regulations on ESOS: Non Transferability of Options

- * Option granted to an employee shall not be transferable to any person
- * No person other than the employee to whom the option is granted shall be entitled to exercise the option
- * The option granted to the employee shall not be pledged, hypothecated, mortgaged or otherwise alienated in any other manner
- * In the event of the death of employee while in employment, all the option granted to him till such date shall vest in the legal heirs or nominees of the deceased employee
- * In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day
- * In the event of resignation or termination of the employee, all options not vested as on that day shall expire. However, the employee shall, subject to the provision of clause 5.3 (b) which mentions the conditions under which option vested in employees may lapse in case of termination of employment for misconduct, be entitled to retain all the vested options



India – SEBI Regulations on ESOS : Accounting policies

- * In respect of options granted during any accounting period, the accounting value of the options shall be treated as another form of employee compensation in the financial statements of the company
- * The accounting value of options shall be equal to the aggregate, over all employee stock options granted during the accounting period
 - ◇ of the intrinsic value of the option, or
 - ◇ if the company so chooses, the fair value of the option
- * The accounting value is accounted for as employee compensation & the amount shall be amortized on a straight-line basis over the vesting period
- * When an unvested option lapses by virtue of the employee not conforming to the vesting conditions after the accounting value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed
- * When a vested option lapses on expiry of the exercise period, after the fair value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense



India – SEBI Regulations on ESOS: Formation & Duties of Compensation Committee

- * No ESOS shall be offered unless the necessary disclosures are made by the company to the prospective option grantees and a Compensation Committee is constituted for administration and superintendence of the ESOS
- * The Compensation Committee shall be a Committee of the Board of directors consisting of a majority of independent directors
- * The Compensation Committee shall inter alia formulate the terms and conditions as on the below items:
 - ❖ the quantum of option to be granted per employee and in aggregate
 - ❖ the conditions under which option vested in employees may lapse in case of termination of employment for misconduct;
 - ❖ the exercise period within which the employee should exercise the option
 - ❖ the specified time period within which the employee shall exercise the vested options in the event of termination or resignation of an employee.

India – Income Tax Regulations for ESOS (1)

- * Stock Option plan/scheme as approved by the shareholders of the Company has to be filed with the Chief Commissioner of Income tax within 6 months of shareholder approval
- * If stock option scheme is in accordance with SEBI/RBI guidelines, the same shall not be taxed as a perquisite/salary at the time of vesting/exercise. The taxability shall be deferred till the time of sale.
- * If the scheme does not meet with the RBI/SEBI guidelines, then taxability shall be at two levels:
 - ❖ level 1 at the time of exercise – as salary income, the income being difference of exercise price and FMV on the date of exercise
 - ❖ level 2 at the time of sale – as capital gains, the gains being difference between sales value and FMV at the time of exercise

India – Income Tax Regulations for ESOS (2)

- * If the plan meets the RBI & SEBI regulations, the following tax treatment applies in India as on May 2005:
 - ❖ short-term Capital Gain tax: if option converted shares were held for a period less than or equal to 12 months from the date of allotment of shares post exercise and if the shares are sold in a stock exchange, then 10% tax will apply on the gains realized (difference between the sale price & the exercise price)
 - ❖ long-term Capital Gain tax: if option converted shares were held for a period more than 12 months from the date of allotment of shares post exercise and if the shares are sold in a stock exchange, then 0% tax will apply on the gains realized (difference between the sale price & the exercise price)
 - ❖ security Transaction Tax: 0.075% of the volume of transaction (Buying/Selling) is taxed as Security Transaction Tax (STT) when the transaction is routed through the stock exchange
 - ❖ if the transaction is routed outside the stock exchange i.e. either direct selling/buying or through a depository, the short-term capital gain tax will 10% & long-term capital gain tax will 30% at the same earlier definition of ST/LT durations

Recent Developments Elsewhere in Asia



Recent Development Elsewhere in Asia

- * Japan
- * Malaysia
- * Singapore
- * Taiwan



Japan

- * Characterisation of share option income has been much debated
 - ❖ "employment income" or "occasional income"?
 - ❖ "occasional income" taxed at substantially lower rates
 - ❖ string of conflicting rulings since 2002; over 100 taxpayer cases pending
 - ❖ Tokyo High Court rulings (Feb 2004) that "employment income"
- * Supreme Court ruling (Jan 2005) in favour of tax authorities → option income is "employment income"
- * **Action point:** communications should clarify that option income can no longer be reported as "occasional income"



Malaysia

- * Relaxation of exchange controls
 - ❖ simplified notification/filing requirements with Bank of Negara
 - ❖ registration required on remittances exceeding RM50,000 (previously RM10,000) per investment
- * Taxation of share options
 - ❖ benefit taxable at grant, but tax payable on exercise - previously Malaysian Inland Revenue Board (MIRB) has taken 1-3 years to confirm taxable amount

Malaysia

- * MIRB ruling (No. 4/2004) (Dec 2004)
 - ❖ new guidance on calculation of taxable benefit
 - ❖ Eer can now calculate taxable benefit without awaiting MIRB approval
 - ❖ filing/notification obligations within 30 days after expiry of offer acceptance period
 - ❖ expedites process for option grants and Eee knows sooner amount of tax payable

Singapore

- * Proposed changes to securities regime
 - ❖ employee share scheme exemption would remain (i.e. no filing or approval requirements if exemption applies)
 - ❖ proposed new exemptions (offers up to 20 pre-identified offerees/small offerings)

Singapore

- * "Deemed exercise rule"
 - ❖ foreign employees normally taxed on "deemed exercise" basis on unexercised options/unvested awards on employment termination
 - ❖ Inland Revenue Authority of Singapore Supplementary Circular 2004/IT/9 (Aug 2004)
 - Eers may now use "tracking option", i.e. account for tax on income realisation event
 - strict qualifying criteria, administrative and reporting requirements
 - high penalties for non-compliance (tax due, plus 200% of that tax)



Taiwan

- * Taiwan Ministry of Finance Tax rulings (TMF) (April 2004) on option grants by Taiwanese companies
 - ❖ "spread" on option exercise categorised as "other income"
 - ❖ no withholding by Eer, but reporting obligation
- * Further TMF ruling expected on option grants by foreign companies – initial proposals
 - ❖ tax on option exercise on "spread"
 - ❖ no withholding/reporting obligation if cost not recharged to local Eer



Questions?

Thank you for your participation