Whitepaper

Stock Appreciation Rights

1 Introduction

1.1 Stock Appreciation Right (SAR) is one of the alternatives adopted for implementing an equity based compensation plan like Employee Stock Option Plan (ESOP), Employee Stock Purchase Plan (ESPP) or Restricted Stock Units (RSU). SARs can be further structured as either 'Equity settled–SARs' or 'Cash settled–SARs'. The Cash settled-SARs are known as Phantom Options.

1.2 SARs as a concept contemplate passing-on of appreciation in the value of certain number of equity shares to the employees without requiring any payment from employee's side. It offers benefits to the company in terms of lower equity dilution and accounting cost as compared to other alternatives.

1.3 SARs are recognized globally as one of the popular instruments of stock based compensation. Following the global trend, SARs are slowly gaining popularity in India as evidenced in SEBI's intention to regulate SARs under its recently enacted Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 (SEBI SBEB Regulations).

1.4 In this context, it will be useful to explore SARs to evaluate if they offer any advantage from different perspectives namely, equity dilution, accounting and tax implications, employee and employer convenience, etc. This may help not only getting a closer insight into this less explored instrument in India, but also provide thoughts for rationalizing any existing scheme or bringing out a new scheme.

2 Concept

2.1 As per SEBI SBEB Regulations, the term SAR conveys a right given to an employee entitling him to receive the appreciation of the market price of share of the Company on the date of vest or exercise of that right, as the case may be, over the SAR price/ base price. The appreciation is made either by way of cash payment or shares of the Company. The same concept is reflected.

2.2 The SARs essentially pass through the same life cycle as ESOPs/ RSUs. The stages of the SAR implementation are (i) grant, (ii) vest, (iii) exercise, and (iv) sale of shares in case of Equity settled-SARs.

2.3 The concept can be understood with an instance. Say, a Company grants 10,000 SARs today (Y^0) to an employee with an equal annual vesting schedule over 4 years (Y^1 to Y^4) with an exercise period of 1 year given the following market prices over the period. The appreciationcan be determined as under:

S.No	Particulars	Y0	Y1	Y2	Y3	Y4	Total
1	Market price	Rs. 100 (Base price)	Rs.150	Rs.200	Rs.275	Rs.350	
2	Less: Base price(SAR Price)		Rs.100	Rs.100	Rs. 100	Rs.100	
3	Annual vesting percentage		25%	25%	25%	25%	100%
4	Appreciation per SAR (1-2)		Rs. 50	Rs.100	Rs.175	Rs.250	
5	Annual vesting of SARs (1000*25%)		2,500	2,500	2,500	2,500	10,000
6	Cash –for cash settlement(4x 5)		Rs.125,000	Rs.250,000	Rs.437,500	Rs.625,000	Rs.1437,500
7	Equity –for Equity settlement(6 / 1)		833	1,250	1,590	1,785	5,458

2.4 The mode of settlement is defined beforehand at the time of grant of SARs. There might be any one of the following choices of settlement of appreciation:
(i) Settlement only by way of equity shares;
(ii) Settlement either by way of equity shares or cash payment at the option of the Company;
(iii) Settlement either by way of equity shares or cash payment at the option of the Employee;
(iv) Settlement only by way of cash payment (where Company may deal with shares of the Company through Trust route); and
(v) Settlement only by way of cash payment (without Company's dealing in shares directly or

indirectly).

2.5 Given the choices above, a Company may adopt one on evaluation of respective choices conforming to its requirements or constraints.

3 Comparative effectiveness

3.1 A comparison vis-à-vis other similar natured alternatives namely, ESOPs and RSUs, may reveal the effectiveness of SARs. Company specific desirable outcomes and constraints are considered while designing an equity based compensation scheme. Some of the desirable outcomes may be in terms of minimum accounting cost, minimum outflow by the employees, taxability of employees, tax deductibility cost incurred by the company, possibility of upward appreciation in the hands of employees, convenient administration, etc. whereas constraints may be in terms of maximum equity shareholding that can be diluted by Promoters/ existing Shareholders, cash expense depending on cash flow projections, etc.

Alternatives/ Parameters	**ESOPs**	**RSUs**	**Equity settled - SARs**	**Cash settled - SARs**
Vesting period	Vesting over the period			
Vesting conditions	Time based / Performance based			
Performance measure	Individual / Corporate			
Outflow by employee	High outflow of market price as on date of grant	Minimal outflow of face value	No outflow*	No outflow
Tax liability on the employee	Perquisite tax on exercise	Perquisite tax on exercise	Perquisite tax on exercise	Perquisite tax on cash receipt
Employee ownership	Achieved	Achieved	Achieved	Not achieved
Upward appreciation	Possible	Possible	Possible	Not possible
Equity dilution	High	Moderately low	Moderately low	No dilution
Accounting cost /Cash payout	No Accounting cost	High accounting cost	No accounting cost	Cash payout
Tax deductibility of accounting cost	Not applicable	Uncertain#	Not applicable	Cash cost is tax deductible

* Though in principle nothing is payable by the employee in Equity settled-SAR, but as a legal requirement (under Section 53 of the Companies Act, 2013), the employee has to pay at least the face value. However, even this minimum outflow by the employee may be avoided with an appropriate Trust route structure.

Company may claim the accounting cost as per decision of Special Bench of Income Tax Appellate Tribunal, Bangalore, which may not be accepted by the Tax Authorities in the absence of any law in the Income Tax Act, 1961 or in a precedent by Supreme Court.

3.2 As can be seen from the table above, SARs do have an edge vis-à-vis other instruments on several parameters.

3.3 Apart from proponents for an Equity settled-SAR Scheme, certain other overriding restrictions on further issue of equity (irrespective of financial health of the Company) may prompt to prefer Cash settled-SAR Scheme. These are as under:

a) Promoters want to share the growth in the economic value of equity, but not equity itself.

b) The Company cannot offer conventional equity based alternatives, because of corporaterestrictions, say, a Joint-Venture or Shareholding Agreement.

c) The Company has exhausted its equity under one or more equity plans but still desires to incentivize on a equity based plan, perhaps without providing stock itself.

d) The Company belongs to a group and wishes to use equity shares of a group Company which is restricted under law - Cash settled-SARs benchmarked with equity of that group Company may work in such cases.

e) When a larger chunk of lower Management personnel are intended to be covered – as they prefer cash over equity.

4 Legal provisions

4.1 Neither the erstwhile Companies Act, 1956 nor SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 (SEBI ESOP Guidelines) which ruled up to recent past, mentioned anything about SAR schemes. Hitherto, the Indian Companies whether listed or unlisted desirous of the SAR structure however used to implement the same treating SARs as a variant of ESOPs in due compliance of the ESOP related regulatory requirements - as the core principle remains the same in both the cases.

4.2 SEBI SBEB Regulations which came into force on October 28, 2014 formally recognized SARs indicating that SARs would now be regulated and subject to procedural requirements in almost same manner as that of ESOPs in case of listed Companies.

4.3 In case of unlisted Companies, as the Companies Act, 2013 read with relevant Companies

Rules, 2014 is silent on this aspect, a Company should adopt SARs mutatis mutandis treating it a variant of ESOPs and accordingly comply with all procedural requirements as prescribed under the relevant Company Rules governing ESOPs. Otherwise, in the absence of any specific provisions or guidelines, the unlisted Companies may follow SEBI SBEB Regulations as best practice to the extent practicable for them.

4.4 Apart from Regulations in Chapter I and II of SEBI SBEB Regulations that prescribe for procedural compliances in respect of SARs in general that equally apply to ESOPs and ESPSs, Part C of Chapter III of the SEBI SBEB Regulations specifically deals with SARs.

4.5 However, it may be noted that an SAR Scheme of a listed Company which does not contemplate dealing in securities of such Company in any manner shall be out of purview of these Regulations. Similar is the case with unlisted Companies. In these cases, the Cash settled-SAR Schemes would ideally be logic driven rather than legally regulated.

5 Implementation/structure

5.1 Suitability of SARs for a particular Company and the structure of implementation depends on desirables or constraints typical to that Company. Implementation and structure should take into account many permutation and combination out of Trust route or direct route, primary or secondary shares, cash settlement or equity settlement.

5.2 Normally, Trust route of implementation is preferred if there are dilution constraints and secondary shares are to be sourced from market. Concern for equity dilution can also be addressed through a Cash settled-SAR Scheme.

6 Tax and accounting

Tax implication in the hands of employees

6.1 In case of Equity settled-SARs:

a) Perquisite tax: As per Section 17(2)(vi) of the Income Tax Act, 1961 the taxable value of perquisite refers to ‘value of equity shares issued or transferred to the employee as on date of exercise’ as reduced by ‘amount recovered from employee’. As per Rule 3(8) of the Income Tax Rules, 1962 value of listed equity shares refers to average of opening and closing market price of equity shares on the relevant Stock Exchange. In case of unlisted equity shares, the value refers to the fair market value of equity share as on date of exercise as determined by a Category-I Merchant Banker registered with SEBI. This tax is determined as on date of exercise of SARs at the rate of tax that applies to Salary of that individual employee.

b) Capital gains tax: Further, at the time of sale of equity shares, the employee is liable to pay income tax on the capital gain arising out of such sale. The capital gain refers to the excess of 'sales consideration of shares' over the 'cost of acquisition of shares'. As per section 49(2AA) of the Income Tax Act, the cost of acquisition refers to the value of such shares as on date of exercise of SARs which was considered for perquisite tax etermination. Long-term gains are taxed at preferential rates than the short-term capital gains. Even at times, the long-term capital gains exempt in case of listed shares.

6.2 In case of Cash settled-SARs:

The amount of appreciation received by way of cash payment from the Company is subject to tax in the hands of the employee as perquisite. It is treated as part of salary and is accordingly taxed.

Tax implications in the hands of Company

6.3 As a consequence of perquisites being taxable at the time of exercise of equity / cash settled SARs as salary, the Company is liable for tax deduction at source under Section 192 of the Income Tax Act.

6.4 In case of Equity settled-SARs, the Company may claim deduction up to perquisite earned by the employees on the basis of decision of Special Bench of Income Tax Appellate Tribunal, Bangalore which was rendered in ESOP context. The principle upheld was that perquisite earned by an employee is at the cost of the Company which is a claimable expense. However, in the absence of any supporting provisions in the Income Tax Act or precedent of Supreme Court, acceptability of such claim by the Tax Authorities in other Jurisdictions is not certain.

6.5 In case of Cash settled-SARs, the cash compensation made by the Company is deductible as allowable expenditure under Section 37 of Income Tax Act.

6.6 **Accounting implications**

a) Equity settled-SARs:
The principle of accounting cost recognition is that there must be some cost (whether notional or otherwise) to the Company. With the presumption that Equity settled-SARs shall be granted with reference to the fair market value/ market price of shares as on date of grant of such SARs (i.e. without any discount), there shall not be any accounting cost with reference to intrinsic value method prescribed under the Guidance Note issued by ICAI. However, the scenario would change in case a Company adopts IFRS 2 for accounting of employee share based payment in which case the fair value of SARs (as per Black Scholes or other prescribed Binomial Method) shall be accounted for.

b) Cash settled-SARs:
As per Appendix-IV of the Guidance Note issued by ICAI, the Company is required to make provisions for estimated cash requirement for settlement on the basis of estimated Fair Market Value as at end of each financial year till the estimated life of SARs or actual exercise/ settlement of SARs, whichever is earlier. As and when any cash payment is madeon account of settlement of SARs, the provision is accordingly adjusted.

7 SARs in practice

7.1 NCEO, a nonprofit research organization based in the United States, has recently conducted a Survey (NCEO 2014 Survey of Executive Compensation) on use of different instruments in equity based compensation by Companies having global presence which depicted that around 50% Companies adopted SARs with an option for either equity or cash settlement, followed by Cash settled-SARs (Phantoms Options) by around 25% Companies.

7.2 In India, a Survey conducted by ESOP Direct in year 2014 reveals that only 10% Companies have adopted instruments including Equity settled and Cash settled SARs. Most of the companies who implemented Instruments other than ESOPs said that the reason was either to manage equity dilution and/ or accounting charge. Few Companies also mentioned that review of compensation strategy and industry practice was the reason for implementing instruments other than ESOPs.

8 Concluding remarks

Given the optimization potential of SARs, the global practice, and the fact of recognition of SARs by SEBI in the Regulations, it is appreciated that the Indian Industry may show interest in examining the effectiveness and adopting SARs which up till now have been significantly less used in India. Hopefully, it may prove to be an effective tool for the achievement of objectives not only from the perspectives of the Management but also from Shareholders' wealth maximization point of view and stand test of time.

About Qapita

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Get in touch with us

www.qapita.com

+91 86002 63374

info@qapita.com

Pune | Mumbai | Hyderabad | Bengaluru | Chennai | Delhi | Singapore