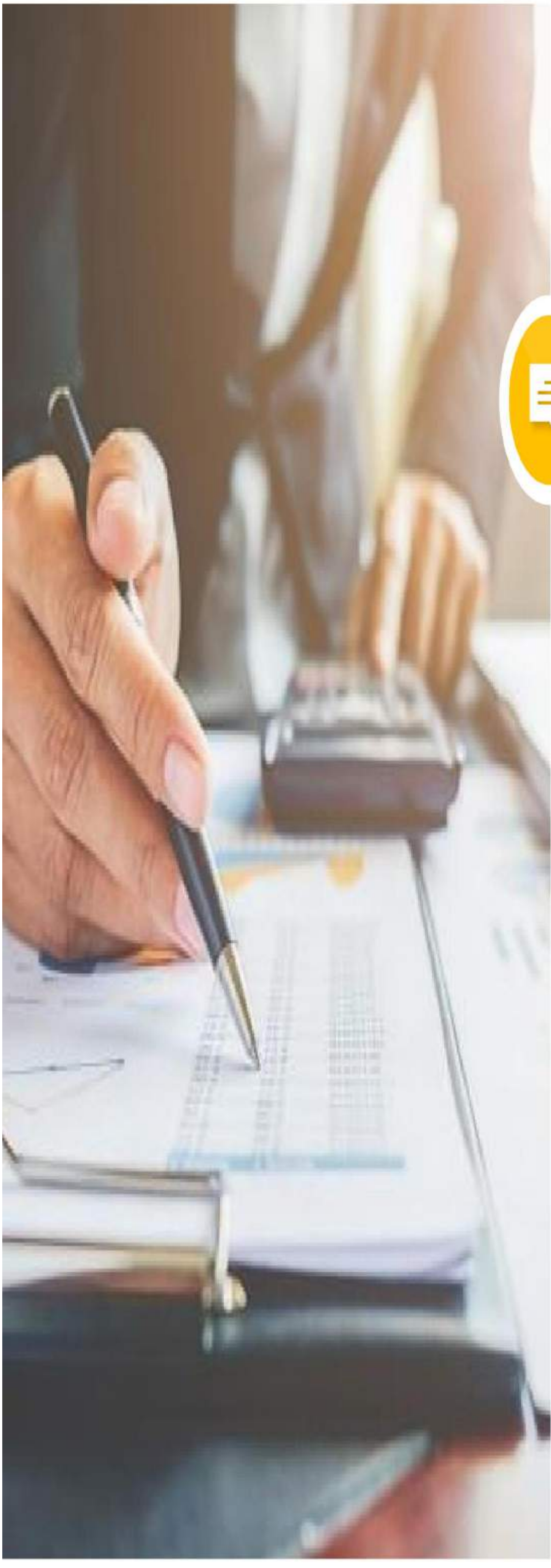
RJA

Rajput Jain & Associates

Chartered Accountants

An ISO 9001:2008 Certified Firm



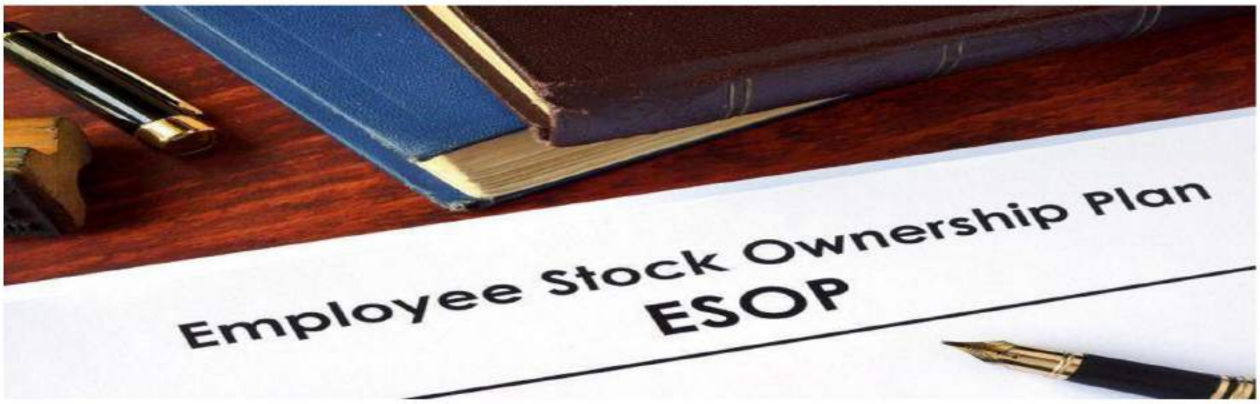
About Us

Rajput Jain & Associates, Chartered Accountants, is one of the leading providers of financial and business advisory, internal audit, statutory audit, corporate governance, & international taxation and regulatory services. With a global approach to service delivery, we are responds to clients' complex business challenges with a broad range of services

across industry sectors and national boundaries. The Firm has been set up by a group of energetic, open minded, highly skilled and motivated professionals who have gained experience from top consulting companies and are extensively experienced in their chosen fields has providing a wide array of Accounting, Auditing, Assurance, Risk, Taxation, & Business advisory services to various clients & their stake holders. We have been associated with various national & International recognized associations in the field of our profession; Association of International tax consultants (AITC) is one of them.

RJA

EMPLOYEE STOCK OPTION PLAN



BRIEF INTRODUCTION

Employee Stock Option Plan, can be defined as a plan, which provides long-term benefits, to the employees of the company, in the form of an option to participate in the equity ownership of the company at an amount less than the fair market value of those shares. In short, a group of employees are identified by a company on the basis of their performance or pay scale, and such identified employees are provided with an option to take up, predefined lot of shares, at a predetermined price, which is at a discount to the FMV.

BENEFITS

As we know, employees are the core asset of any Business. Thus, retention of the best is very important. ESOP was introduced, as the means of the most comprehensive and attractive tool for employee reward and retention. Through this process, the employees are offered stake in the ownership of the Company, which will thereby, results in boosting employee morale and loyalty towards the organization.

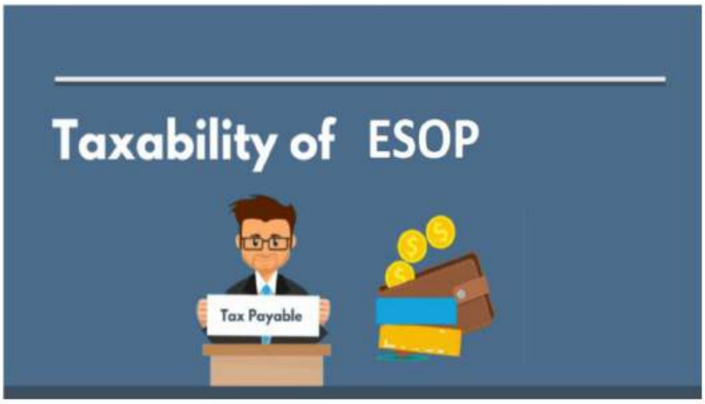
1. **MARKET FOR SHARES OF DEPARTING OWNER –** Where any owner of a company wants to depart or leave the business, their holding in the companies, instead of transferring to some unknown person and also there is no guarantee that a buyer will be available. Thus, the company can use ESOP as a means of creating a ready market for their shares. By undertaking such an option, the company makes a tax-deductible cash contribution to the ESOP to buy out an owner's shares.

2. **LOWER COST OF BORROWINGS –** As discussed above, ESOPs is a tax-deductible cash contribution, to borrow money. The ESOP borrows cash from the company, and then uses it to buy company shares or shares of departing owners. Later, the company will make the tax-deductible contributions to the ESOP to repay the loan, thus having both principal and interest deductible from the profit.

3. **ADDITIONAL BENEFIT -** A company can issue treasury shares under an ESOP, and deduct the value of shares taken up by employees, from their taxable income. Else, the company can contribute cash, and buy the share of departing public or private owners. In public companies, ESOP is used as a means of employee long term savings plan, which can account for about 5% of the plans and about 40% of the plan participants.

TAXABILITY

The Section 17(2)(vi) of the Income Tax Act, 1961, defines perquisites as the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or any other former employer, to its employees, either free of cost or at concessional rate.



1. In the above definition, specified security means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and, includes securities issued under the plan of ESOP.
2. In order to calculate the gain on such ESOP, the value of the specified security or sweat equity shares shall be taken as the fair market value of these securities, as on the date on which the option is exercised by the concerned employee. The gain shall be such FMV, as reduced by the amount actually paid or recovered from the employees.

TAXATION ON TWO STAGES

1. As discussed above, the securities issued under ESOP, comes under the definition of perquisite and thus, the same be taxed in the hands of employees as perquisite.

   - **TAXABLE VALUE OF PERQUISITE -** The value of such perquisite shall be – (FMV on the date of exercise per share – Exercise price per share) x number of options exercised.
     For example, Company XYZ provided its employee Mr. A, with an option to take up 5000 shares of the company under the scheme of

ESOP. The FMV on the date of exercise is Rs 150 per share and the Mr. A can take up these shares at Rs 75 per share.
Thus, the amount of perquisite will be (150-75) *5000 = Rs 37500. This amount of Rs 37500 will be included in the salary of Mr. A, in the year, the shares are allotted to him. Also, the employer is required to deduct TDS on such an amount of perquisite.

- Also, where the employee is unable to pay TDS, many companies provide an option to sell some shares from the total shares to be allotted to the employee. Such sale of shares will amount to transfer of shares by the employee and capital gain provision will be welcomed. Such transfers always account for short term capital gain, as they are transferred just when they are allotted. For calculating the capital gain on such a transfer, the cost of acquisition shall be the FMV on the date of exercise.

2. Second stage of taxation comes, when the employee decides to sell some or all the shares after the lock in period. Whenever these securities are sold, capital gain or loss is accounted for in such transactions. Different tax rates are applicable on capital gain, based on the type of security and most importantly, its holding period.

TYPE OF SHARES	HOLDING PERIOD	TYPE OF CAPITAL GAIN	RATE OF TAX
LISTED	UPTO 12 MONTHS	SHORT TERM	15% U/S/ 111A
	MORE THAN 12 MONTHS	LONG TERM	10% IN EXCESS OF Rs 1 LAKH U/S 112A
UNLISTED	UPTO 24 MONTHS	SHORT TERM	NORMAL SLAB RATE
	MORE THAN 24 MONTHS	LONG TERM	20% U/S 112

DISADVANTAGES

1. **OBLIGATION FOR THE COMPANY –** The providing ESOP to its employees, are put under an obligation to issue the required securities on the exercise date. ESOP does not help the company in any other way, except for providing some amount of liquidity and also some tax advantage as well.

Otherwise, it is just like issuing normal stocks. This can make options riskier than normal stocks.

2. **UNCERTAINTY OF FUNDS –** There is a greater insecurity of liquidity, as the funds will come only when the employees exercise their respective options. Thus, the amount is uncertain till the date of the exercise and the liquidity benefits with ESOPs is highly uncertain.

3. **IMPROPER VALUATION NORMS –** As per the Companies Act, 2013, it is still unclear about various guidelines related to the valuation and accounting procedure for ESOPs in a company.

TAXATION AFTER BUDGET 2020

As discussed in the above part, ESOP is a perquisite in the hands of employees of the company and the same is subjected to income tax (30%+) on the full value of perquisite less the price paid for it. But for start-up, such an option is quite a great source of fund, if we exclude the aspects of tax and compliance. Thus, in order to benefit the start-up to come up with a great number, amendments were made in the Budget in 2020. As a result, a slew of measures was undertaken by the Government of India, for the benefit of the Indian start-up sector. The Government decided to defer the payment of income tax on ESOPs from the time of exercise of ESOPs. Under the new provisions, the tax liability for start-ups arises within 14 days from the earlier of the following -

1. Date after the expiry of 48 months from the end of the PY in which ESOP is exercised/allotted.
2. Date when such shares have been transferred or sold by the employee.
3. Date from which the employee ceases to be an employee of the ESOP issuing company.

Budget also deferred the liability of the employer to deduct TDS on the ESOP by start-ups.

ELIGIBILITY FOR ABOVE RELAXATION

1. The start-up was incorporated on and after 1stApril, 2016 and before 1st April, 2021.
2. And the annual turnover of such a start-up does not exceed Rs 25 crores during any of the previous years.
3. Also, the business be in receipt of a certificate of eligible start-up issued by the Inter-Ministerial Board of certification as notified in the Official Gazette by the Central Government.

Such a system of deferring tax payment on ESOPs will help start-ups gain high-quality employees. Deferring of tax means that the employee is relieved from the burden of paying tax when the shares are allotted. Hence, they will pay tax at the time of selling the exercised shares and the tax can be paid from the proceeds of such sale. Also, the time period of 48 months from the end of the assessment year when the ESOPs were exercised, for selling the share, is a pretty good time and also the share will become long term capital assets, thus the tax rate will also be less. Also, in case the employee wishes to leave the company, the company can take up these shares and the same be taxed at that time, which will indeed help the company from retaining its own shares.

RESTRICTED STOCK UNITS RSU IN INDIA

INTRODUCTION

RSU are Restricted Stock Units that are provided by foreign companies to their employees as a means of compensation for their worthy service to their business. RSU is taxable in India and is considered just like ESOPs.

- Since RSUs are issued by foreign companies, the same shall not be listed on any recognised stock exchange in India. Thus, no STT (Security Transaction Tax) shall be paid in relation to such stocks.
- Such securities shall be termed as short-term capital assets, where the period of holding is up to 24 months. When they are transferred, Short-term capital gains arise and the same is taxed at the employee's normal income tax slab rates.
- In case, RSUs are held for a period exceeding 24 months, they are termed as long-term capital assets. When they are transferred, long term capital gain arises and the same is taxed @ 20% along with indexation benefit.

In case the assessee has already paid some tax in respect of such RSUs, he can claim credit of same in India, at the time of filing their annual return, provided such country is in DTAA agreement with India and such agreement allows the assessee to take the credit in India.

ROUTES TO ISSUE ESOP

Under Companies Act, 2013, a company can issue ESOP to its employees through two modes, namely - Direct Route and Trust Route:

1. **DIRECT ROUTE –** Under direct route, the company directly grants the options to the employees. At the time of exercise, fresh equity shares are allotted to the eligible employees. Thus, the direct route is a one-to-one dealing between company and employees.

PROCEDURE

- The board of directors of the company prepares the scheme of ESOP and passes a resolution for the same.
- The scheme is then proposed to the Remuneration Committee for their approval.
- Once the approval is received, the board shall call for a meeting of its shareholder.
- The meeting is convened and the scheme is proposed to all the shareholders. The notice supplied shall contain the details of the employees to whom the ESOP is granted and at what price.
- The shareholder shall approve the scheme by passing a special resolution.
- After successful approvals, the board issues a letter of offer to respective employees.

2. **TRUST ROUTE –** This route is gaining greater recognition in today's world and is preferred by listed entities. Under this, the company creates a trust in the name of ESOP Trust, for the purpose of running the ESOP schemes. Employees interested in exercising the option to acquire the shares, would acquire it from the trust instead of from the company. The company shall first transfer the required shares in the name of trust using the secondary market or direct allotment and the trust will then issue the same to the exercising employees.
   The trusts are funded by the company to purchase the requisite shares from the secondary market and when the employees pay the trust for taking up the share, the trust pays back the company. Also, whenever an employee wishes to sell the shares, the trust formed can take up such shares and by this the company can avoid transferring of shares to any unknown person.

CONDITIONS

- The creation of trust shall be done after a separate special resolution by the shareholders for the same.
- Where the company is listed on Stock Exchange in India, the trust can acquire the share of the company, only through the secondary market.
- In the case of an unlisted company, the trust can purchase the shares through the valuation done by an Independent Registered valuer.
- The total shares held by the trust shall not exceed 5%. of the aggregate of paid up capital and free reserves of the company, at any point of time.

PROCEDURE

1. The board of directors of the company prepares the scheme of ESOP and passes a resolution for the same.
2. The scheme is then proposed to the Remuneration Committee for their approval.

3. Once the approval is received, the board shall call for a meeting of its shareholder.
4. The meeting be convened and the scheme be proposed to all the shareholders and also a separate resolution be passed for creation of trust. The notice supplied shall contain the details of the employees to whom the ESOP is granted and at what price.
5. The shareholder shall approve the scheme by passing a special resolution.
6. After successful approvals, the board issues a letter of offer to respective employees.
7. Then prepare the Trust Deed under the Indian Trusts Act for the proposed trust and register the same with the jurisdictional Sub-Registrar.
8. File application for obtaining PAN for the Trust and Open Bank Account using the PAN obtained.
9. Determine the number of shares and their value, required to be allotted to the Trust for subsequent transfer to the employees.
10. Obtain Valuation Report from a Registered Valuer for the value of the Shares, in case the company is unlisted.
11. Initiate the procedure to provide loan to the Trust, to purchase the required number of Shares at the predetermined price.
12. Make the allotment of share to the trust.
13. The trust will then transfer/sale the shares to the eligible employees respectively at the Exercise Price as determined in accordance with the ESOP Scheme
14. On receipt of Exercise Price, the trust shall repay the loan back to the Company.

COMPLIANCES

1. **APPOINTMENT OF TRUSTEES –** The board can appoint any person as the trustee of the ESOP Trust, except for the following –

- Directors, Key Managerial Personnel of the company as well as their relatives.
- Directors, Key Managerial Personnel of the holding or subsidiary company of the concerned company.
- Any beneficial owner holding more than 10% of the paid-up share capital of the company.

2. **DISCLOSURES UNDER BOARD'S REPORT –** on successful initiation of scheme, the company shall, specify the details of the ESOP scheme as per the provisions of the Companies Act, in its Board's Report for the year in which the scheme is initiated.

3. **REGISTER OF ESOP –** The company is also required to maintain a separate register in the name of Register of Employee Stock Options in Form no. SH.6 and shall enter the details pertaining to each ESOP granted.

ISSUES

From the above information, we can very well make out that ESOPsare accompanied with complex rules and regulations. Companies require a proper administration system for providing stock ownership to the employees and in the event of failure, it may invite certain risk issues and penalties. Upon establishing ESOPs the company must have proper administration, staff, including third-party administration, legal costs, and trustees and be aware of the costs that will be incurred while providing this facility.

CONCLUSION

Concluding the above article, it can be made outthat ESOP is a great way to build the foundation of financial freedom and retirement. As a means of motivation, ESOP makes the employees more inclined to work towards the goal of the company. They feel pride and could connect with the company, when provided with the ownership of the company and thus, ESOP turns to be a measure of success for a company.

Connect with Us:

CORPORATE OFFICE

P-6/90, Connaught circus
Connaught Place New Delhi 11001
Phone no.9555555480
Email.info@carajput.com
www.carajput.com

We are the exclusive member of in India of the Association of international tax consultants, an association of independent professional firms represented throughout worldwide