# ESOP -EMPLOYEES STOCK OPTION PLAN

**What is ESOP?**


Definition of ESOP given under Section 2(37) of the Companies Act, 2013.It defines employees stock option as the option given to the directors, employees or officers of the company or of its holding or subsidiary company, the right to purchase or benefit or subscribe for the shares of the company at a predetermined price on a future date.

Therefore the Employee Stock Option Plan (ESOP) is an employee benefit plan. It is issued by the company for its employees to encourage employee ownership in the company.

**Why ESOP? What are the benefit of ESOP:**

- It rewards the employees for the effort they put in.
- Enhances Job satisfaction.
- Retention of talent in the Company.
- Employees stay loyal to the company for a longer period. Increases motivation
- It benefits the startups where employees can be rewarded after the company goes public.
- Deferred compensation strategy
- Good retirement benefit plan

**Why ESOPs considered more beneficial for Start- ups?**

- Startups are cash-short, therefore ESOP is the best way to compensate employees
- Employees will get aligned to the interest of company
- Start ups allowed to offer ESOPs to Promoters & Directors holding more than 10% of the outstanding equity share capital of the company – which is otherwise not allowed.

## To Whom ESOPs can be issued?

Rule 12(1) of Companies (Share Capital and Debentures) Rules, 2014 states that ESOP can be issued to the following employees-

- A permanent employee of the company who is working in India or outside India
- A Director of the company, including a whole-time or part-time director but not an independent director.
- A permanent employee or director of a subsidiary company in India or outside India, or holding company, or an associate company.

It cannot be issued to-

- An employee who is belonging to the promoter group or is a promoter of the company.
- A director who either himself or through any body corporate or through his relative holds more than ten per cent of the outstanding equity shares of the company, whether directly or indirectly.

**Note: However, the above two conditions do not apply to Startup Companies for a period of ten years from the date of its incorporation**

## Process of ESOP?

Section 62(1)(b) of the Companies Act, 2013 and Rule 12 of Companies (Share Capital and Debentures) Rules, 2014 ("Rules") governs the issuance of ESOP. The procedure for issuance of ESOP under the Rules is similar to that of the procedure under the Securities and Exchange Board of India Employee Stock Option Scheme Guidelines for listed companies. The process for issuing ESOP by a company are:

- Prepare the draft of ESOP in accordance with the Companies Act, 2013 and Rules.
- Pass the board resolution for the issuance of shares through ESOP, determine the price of shares to be issued pursuant to ESOP and fix time and date and approve for calling the general meeting to pass a special resolution for issuing ESOP.
- File MGT-14 form with the Registrar of Companies of passing the board resolution.
- Pass the special resolution for the issuance of shares under the ESOP to the employees, directors and officers of the company in the general meeting.

- File MGT-14 form with the Registrar of Companies for passing the special resolution.
- Send options to the employees, directors and officers of the company for purchasing shares under ESOP.
- Maintain a 'Register of Employee Stock Options' in Form No.SH-6 and enter the particulars of the ESOP granted to the employees, directors or officers of the company.
- If a private company wants to issue ESOP, then it should ensure that the Articles of Association (AoA) authorises for issuance of shares through ESOP. If the AoA does not authorise, then the company should first hold an extraordinary general meeting to alter the AoA to include the provisions of issuance of shares through ESOP and then proceed with holding the board meeting for the passing of the resolution and getting the shareholder's approval for ESOP Scheme.

**What are these Terms of ESOP? Option, Vesting, Exercise**

- **Grant:** **:** Offering of ESOP Options from Company to Employee. The company is free to determine the exercise price.
- **Vest:** Vest means the right of the employees to apply for the shares granted to them. There shall be a minimum of one year between the grant of option and vesting of option for the ESOP scheme.
- **Exercise:** The exercise period is where the employees can exercise the option of buying the shares. The company will have the freedom to specify the lock-in period for the shares issued (if any) after the exercise of the option. The employees will not have the right to receive any dividend or to vote or enjoy the advantages of a shareholder in respect of the ESOP granted to him until the shares are issued on exercise of his option.

**Tax implications of ESOP?**

Tax Implications for Employees-

**I. <u>As perquisites</u>**

At the time of Allotment- Perquisite tax =Fair market value on exercise of options-exercise price

Where they are treated as perquisite and tax is deducted at source. This tax is only deducted when the option is exercised after the vesting period and the shares are sold. Until before the amendment made in the Budget, 2020, this tax was supposed to be paid immediately after the shares had been exercised.

Post 2020 Budget amendment, companies were given certain dates on which they had to pay such tax i.e. 4 years from the end of the year in which the shares were sold, on the date of sale of shares, or on the day the assesse ceases to be an employee.

## II. As Capital gains

At the time of transfer of shares- Capital gain tax =Sales price of shares-FMV at the time of Exercise * Short term capital gain tax rate/long term capital gain tax rate

Where they can be taxed as capital gains, which is essentially the difference between the sale value and the fair market value, from employees who have sold the very shares at a profit.

Tax Implications for Companies- Company has no tax liability, it has to book Compensation Cost in its P&L Account

**Employee Compensation Expense (equivalent to Price Discount)= Market Value- Price at which Shares are offered**

**What are the various types of ESOP?**

**-Employees Stock Option scheme-**Under this scheme, the company grants an option to its employees to acquire shares at a future date at a pre-determined price. Eligible employees are free to acquire shares on vesting within the exercise period. Employees are free to dispose of the shares subject to lock-in-period if any .Generally exercise price is lower than the prevalent market price

**-Employees Stock purchase plan-**This is generally used in listed companies, wherein the employees are given the right to acquire shares of the company immediately, not at a future date as in ESOS, at a price lower than the prevailing market price. Shares issued by listed companies under ESPP will be subject to lock-in-period, as a result, the employee cannot sell the shares and/or the employee has to continue with the employer for a certain number of years

**-Restricted Stock Units-** Under Restricted Stock Units Plan, an Employee is awarded with the right to receive shares on a pre-determined date subject to occurrence of a specified event or fulfillment of specified conditions. In such kind of incentive plans, the Employee becomes shareholder only upon occurrence of a specified event or fulfillment of specified conditions.

**-SAR- Stock Appreciation Rights -Cash settled-** SARs are not technically employee stock options, companies often use them in a like manner. SARs provide employees with cash payments equal to the appreciation of the company's stock over a specified duration. Thus, unlike other options, SARs provide employees with equity upside without exposure to any downside.

**-Share Appreciation Rights (SAR) / Phantom Shares :** Under this scheme, no shares are offered or allotted to the employee. The employee is given the appreciation in the value of shares between two specified dates as an incentive or performance bonus, that is linked to the performance of the company as a whole, as reflected in its share value.

**How will the Pricing be done?**

| Listed Company | Unlisted Company |
|---|---|
| Market Price One day before the grant | Price calculated on the basis of valuation done |

**Regulatory Framework?**

| Unlisted Company | Foreign Companies (Listed + Unlisted) | Listed Company |
|---|---|---|
| -Companies Act,2013 +Rules<br>-Income Tax Act,1961 | FEMA | SEBI (SBEB) Regulations, 2014<br>SEBI (LODR) Regulations,2015<br>SEBI (PIT) Regulations,2015<br>Income Tax Act, 1961 |

**CS Monika Moorjani**

**(9811970129) monikamoorjani@gmail.com/info@csmonika.com**