

EMPLOYEE STOCK OPTION SCHEME (ESOPs)

Employee Stock Option Plans or Employee Stock Option Schemes are the options given by Companies or early stage start-ups to their Employees to own a certain number of shares in the Company at a pre-determined price, but which would vest at a later date. ESOPs are defined under **Section 2(37)** of the Companies Act, 2013, as per which "employees' stock option" means, *the option given to the directors, officers or employees of a company or of its holding company or 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 predetermined price.*

Traditionally, this scheme was necessarily used by the established Companies to reward the well performing employees, but now the early stage start-ups are also extending such benefit to their Employees to ensure their retention in the company, and also, as an additional incentive to the employees, since the start-ups cannot offer lucrative pay checks. Additionally, on the part of the employees, it creates a great incentive as they develop a certain sense of ownership in the company's shares.

It is mandatory for every private company and public unlisted company that proposes to issue Employee Stock Options to employees, to have in place an ESOP scheme that is in consonance with **Section 62 (1)(b)** of the Companies Act, 2013, read with **Rule 12** of the Companies (Share Capital and Debentures) Regulations, 2014 ("ESOP

Regulations”). Prior to these ESOP Regulations, there was no legislation regulating issuance of ESOPs by private companies.

Key Rules:

The ESOP Regulations permit issuance of ESOPs to:

- i.** permanent employees who have been working in India or outside India;
- ii.** directors, excluding Independent Directors; and
- iii.** employees of subsidiaries, associate companies and holding companies.

Further, **Rule 6 (a)** of the Regulations generally stipulates a lock-in period of one year between grant of option and vesting. The period after which the employee becomes entitled to exercise the right to acquire the shares is called as vesting period. Vested options can be exercised at an exercise price which is usually at par for startup companies and at a discount to fair market value for slightly more mature companies. However, as per **Rule 8(d)**, if an Employee is terminated or he (or the Director) resigns, then the options which are yet to be vested shall lapse.

Moreover, the Regulations (**Rule 8(a)**) restricts the transferability of the options, in any manner and also, restricts the rights of the Employees to receive any kinds of dividends or to vote or enjoy in any manner, the benefits of a shareholder in respect of the options granted to them, till shares are issued on exercise of an option. Further, **Rule 12(5)** of the Regulations allows a Company to amend its ESOP scheme (not yet exercised by the Employees) at any time by passing a special resolution, approving

such amendment. However, the amendment in the scheme must not be prejudicial to the existing ESOP holders. The Notice for passing the Special Resolution should disclose the rationale behind the variation and the employees who shall be the beneficiaries of the amendment in the scheme.

Taxability of Employees availing ESOPs:

ESOPs are taxed at 2 instances:

- i. date of exercising of the option by the employee:** When the employee has exercised the option, the difference between the fair market value and exercise price is taxed as perquisite. The employer deducts TDS on this perquisite.
- ii. date of sale by the employee:** The difference between sale price and fair market value on the exercise date is taxed as capital gains. The gains can be either long term or short term depending on the period for which the employee has held the shares.

Taxability for the Employer:

The Income Tax Act, 1961 (“**Act**”) does not explicitly mention the tax applicability on the employer. The main contention is that whether the debits to the P&L a/c with respect to the options will be allowed as a deduction to the Company. As per Section 37 (1) of the Act, an expenditure laid out or expended wholly and exclusively for the purpose of business/ profession shall be allowed in computation of the income

chargeable under the head, “Profits or Gains of Business or Profession”. The Indian Courts have taken this stand that any expenditure incurred by the Company for the welfare of employees is considered as a bona fide business deduction. The motivation to issue stock option for a Company is to attract and retain the best talent, therefore, it may be included as expenditure incurred wholly and exclusively for the purpose of business and such deduction should be allowed. In the case of *Lonappan (C.D.) v CIT (1963 49 ITR 708)*, it was held that the Appellate Tribunal was not justified in disallowing the deduction for a part of the bonus paid to the employees. In another case of *Lowry v Consolidated African Selection Trust Ltd (1940 8 ITR (E.C.) 88)*, the dissenting judges held that the Company issued to its employees shares at par when the market value was at premium, which was done to further the interest of the Company’s trade and to secure a benefit to the Company. The difference in the price was the sum expended for the purpose of trade and was held deductible at the time of calculation of profits. In the case of *Ranbaxy Laboratories Ltd. v Addl. CIT [(2009) 124 TTJ (Delhi) 771]*, it was held that when shares are issued under the ESOP scheme, the amount of option premium has to be treated as employees compensation in the books and to be charged to P&L a/c over the vesting period. Therefore, the cost of such benefit is allowable as business expenditure to the employer.

Once the Company issues the ESOPs, the internal holding of the company increases, which further makes it easier for the companies to implement its managerial decisions. Also, since the ESOPs form a part of the pay package of the employee, it reduces the company's immediate cash outflow. While the benefits of implementing an ESOP scheme are many, there are also few disadvantages attached to the Options as well. It is only the *actual exercise* of option by the employee that enhances the liquidity of the company, which remains highly uncertain. Another limitation may be that Options can become an obligation for the company, as these are given at heavy discounts to the employees, discriminating between ordinary shareholders and the employees, thus creating problems of transparency in corporate governance.

Conclusion:

Granting ESOPs has historically been a mutually beneficial tool for Companies as well as the ESOP holder. The objective behind granting an Option should not be just to ensure good performance but more importantly, to inculcate a sense of ownership for mutual long-term benefit. However, the Companies need to be very careful while granting the ESOPs. It is worthwhile mentioning that care must be taken to ensure that all the options do not get vested in one go as that may encourage an employee to exercise all the options and resign, which may defeat the purpose for which such an option was exercised, in the first place.