EMPLOYEE STOCK OPTION PLAN (ESOP)

Employee Stock Option Plan is a priceless tool for companies to attract and retain talented employees. As a part of an employee's compensation, ESOP creates a sense of ownership in the mind of employees and their interest in the organization remains intact.

ESOPs are beneficial to both employees as well as the Company, if implemented effectively. ESOPs have two-fold benefit i.e. reducing cash outflow and retaining deserving employees for their growth.

Employees also see this scheme as a long-term investment for which they have to compensate with their cash perquisites and bonuses.

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ESOP – AN INTRODUCTION

What are ESOP’s?

An Employee Stock Option Plan (ESOP) is an option given to the employees to buy the shares of the Company.

An Option gives the right to purchase the shares at a pre-determined price, and therefore gives the employee an upside to the current value of the share.

However, until the option is exercised and converted into a share, an option holder does not get any shareholder rights of voting, dividends and the like.

Why ESOP?

• It is a tremendous motivator and can encourage employees involvement in their jobs and enable them to focus on corporate performance.
• It is vital tool to attract and retain quality employees, fostering in them long term attitudes.
• As a compensation tool, Employee Stock Options offer rewards that can exceed the expectations of employees but are still affordable to the company as they are highly performance driven.
• Internationally, Employee Stock Options are used for granting retirement benefits to employees and as succession plan for owners
Granting
Option given to an employee which gives the employee a right to purchase or subscribe at a future date, the shares offered by the Company, at a predetermined price.

Vesting
The process by which the right to apply for shares accrues to eligible employees against the Options Granted to them.

Exercising
Making of an application by an employee to the Company for issue of shares against vested option.
ESOP – FLOW

1. Formation of Employee Stock Option Plan (ESOP)
2. Granting of options
3. Vesting of options
4. Exercise of Options
5. Sale of Shares
ESOP – ELIGIBLE PERSONS

Company

Permanent employee of the Company (including Holding or Subsidiary) who has been working in India or outside India

Director of the Company (including Holding or Subsidiary) (Excluding Independent Director)

ESOP – INELIGIBLE PERSONS

Company (Cannot issue Employee Stock Options)

An employee who is a Promoter or belongs to the Promoter Group

A Director who directly or indirectly holds more than 10% of outstanding equity shares of the Company.

ELIGIBLE STARTUP

“ELIGIBLE START-UP” as defined in Notification G.S.R.501(E) of dated 23rd May 2017 would not be subject to the above limitations for a period upto five years from date of Incorporation or registration.
ESOP – CONDITIONS TO ISSUE

**Time Gap**
At least 1 year between the grant of options and vesting of options

**Valuation**
Valuation of shares at the time of exercise of option

**Non-transferable**
Employee Stock Options granted to the Employees are not transferable
ESOP – METHODS OF IMPLEMENTATION

Through Trust

- Trust will be created for Framing and implementing ESOP
- ESOP Scheme is run by the Trust
- Founder/Specific Shareholders transfer portion of their shares to Trust to create ESOP pool / Company issues shares to the Trust.
- Cost of creating/ Maintaining Trust is high

Through Direct Route

- Employee Stock Option pool will be created by Company through the Board of the Company, shareholder approval and and creation of an ESOP Plan
- The ESOP Scheme is run by the Board / Other Nominated Committee of the Company
- Cost of creating/ Implementing ESOP scheme is relatively low
ESOP – METHODS OF IMPLEMENTATION

Timeline Based

- Vesting will be in “n” of Years as per vesting Schedule
- Number of Options to be vested is fixed

Performance based

- Granting will be based on performance of Employee
- Number of Options to be granted will change depending upon performance
ESOP – REQUIREMENTS AS PER COMPANIES ACT 2013

01 Draft ESOP
- Draft ESOP indicating No of ESOP to be issued, Vesting Period/schedule, Exercise Period, Condition for granting if any
- Company has option to specify Lock –in period for shares issued pursuant to exercise of option

02 Approval of Directors, Shareholders
- Convene Board Meeting and approve schemes
- Call general body meeting of Shareholders and pass the scheme by passing resolution (special resolution if it is other than private limited)

03 File Forms with ROC
- File MGT -14 With ROC for Special resolution

04 Granting, Vesting, Exercise
- Granting Options to eligible employees through Letter of Grant.
- Minimum of 1 year gap between Granting and Vesting Options

05 Compliance
- Company shall maintain register of ESOP in SH-6
- Options shall be disclosed in Director’s Report alongwith details of ESOP
- When options are exercised, PAS-3 has to be filed.
ESOP TAX IMPLICATIONS ON ISSUE, EXERCISE AND
SALE OF ESOP (1/2)

EMPLOYER

- In case any shares are issued by the company under the ESOP scheme on or after 1 April, 2009, then under the provisions of The Income Tax Act 1961, there shall be no tax liability in the hands of employer/Company

EMPLOYEE

At the time of Exercise of ESOP

- Perquisite Taxation: Employees shall be liable to pay tax on fair market value on the date of exercise (-) the exercise price and such amount shall be liable to be taxed as a perquisite paid by the employer to the employee under section 17 of the Income Tax Act, 1961

At the time of sale of ESOP shares

- Capital Gains Tax: Employees shall be liable to pay capital gain tax under section 49 of the Income Tax, and the tax shall be calculated on the amount of difference between the Sale consideration (-) the price at which the shares were acquired (Price on which perquisite tax was paid)
### ESOP TAX IMPLICATIONS ON ISSUE, EXERCISE AND SALE OF ESOP (2/2)

<table>
<thead>
<tr>
<th>CAPITAL GAIN</th>
<th>SALE CONSIDERATION</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less: Expenses on Transfer</td>
</tr>
<tr>
<td></td>
<td>Net Sale Consideration</td>
</tr>
</tbody>
</table>

Less: COST OF ACQUISITION  
(FMV ON DATE OF EXERCISE OF OPTION)

#### CAPITAL GAIN ON SALE OF SHARES

- The Employee Stock Option holder period of equity holding shall be reckoned from date of allotment (exercise of option) or Transfer of such shares as per Explanation to Section 2(42A)

- Period of holding not more than 24 months is considered as Short term Capital assets and taxed at individual slab rate. (Not applicable to Listed Company) - can be used
### SALE OF ESOP SHARES / ESOP EXIT : TAX EXEMPTIONS

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Section 54EC</th>
<th>Section 54F</th>
<th>Section 54EE</th>
</tr>
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<tbody>
<tr>
<td>Eligible taxpayers</td>
<td>Any person</td>
<td>Individual and HUF</td>
<td>Any person</td>
</tr>
<tr>
<td>Capital gains for exemption</td>
<td>Long-term</td>
<td>Long-term</td>
<td>Long-term</td>
</tr>
<tr>
<td>Capital gains arising from transfer of</td>
<td>Any long-term capital asset</td>
<td>Any long term asset (other than a residential house property) provided on date of transfer taxpayer does not own more than one residential house property (except the new house)</td>
<td>Any long-term capital asset</td>
</tr>
<tr>
<td>Assets to be acquired for exemption</td>
<td>Bond of NHAI or REC, etc.</td>
<td>One residential house property</td>
<td>“long-term specified asset” which means a unit or units, issued before the 1st day of April, 2019, of such fund as may be notified by the Central Government in this behalf.</td>
</tr>
<tr>
<td>Time limit for acquiring the new assets</td>
<td>Within 6 months from date of transfer</td>
<td>Purchase: within 1 year before or within 2 years after date of transfer. Construction: within 3 years after date of transfer</td>
<td>within 6 months from the date of transfer</td>
</tr>
<tr>
<td>Exemption Amount</td>
<td>Investment in new assets or capital gains, whichever is lower, however, subject to Rs. 50 lakhs in a financial year and subsequent financial year</td>
<td>Investment in new assets X (capital gain/net consideration)</td>
<td>Investment in new assets or capital gains, whichever is lower, however, subject to Rs. 50 lakhs in a financial year and subsequent financial year</td>
</tr>
</tbody>
</table>
ESOP to Foreign Employee (Requirements for an Indian Company)
The ESOP is drawn either in terms of regulations issued under the Securities and Exchange Board of India Act, 1992 or the Companies (Share Capital and Debentures) Rules, 2014 notified by the Central Government under the Companies Act 2013;

“Employee’s stock option”/ “sweat equity shares” are in compliance with the sectoral cap applicable to the said company;

Issue of “employee’s stock option”/ “sweat equity shares” in a company where investment by a person resident outside India is under the approval route requires prior Government approval.
REPORTING REQUIREMENTS - FEMA

01 At the time of Granting
- The issuing company shall furnish to RBI within 30 days from the date of issue of ESOP or sweat equity shares, a return as per the Form-ESOP

02 At the time of exercise of options
- Indian Company has to obtain KYC of each Employee
- File ARF in 30 days of receipt of funds and FCGPR in 30 days with RBI for the Foreign Investment

03 CA and CS Certificate
- CA Certificate as prescribed along with CS Certificate for adherence to FEMA guidelines

04 File Annual Statement with RBI
- File annual statement of assets and liabilities with RBI

05 Valuation for Entry and Exit
- Exit price can be any price less than or equal to fair value as determined by Chartered Accountant
ESOP from Foreign Parent company to Employee of Indian Subsidiary (Requirements for an Indian Company)
REPORTING RESPONSIBILITY – RESIDENT

FEMA and Companies Act

- General permission has been granted to a person resident in India who is an individual to purchase equity share offered by Foreign companies under ESOP if he is an Employee, director of Foreign Company/Subsidiary of Foreign Companies.
- Shares under ESOP Scheme offered by issuing company globally on uniform basis.
- An Annual Return (Annex – B) is submitted by Indian company to RBI through AD Category – I giving details of remittances/beneficiaries.

FEMA

Companies Act

- In compliance of Section 170 of Companies Act, 2013 & Rule 17 of Companies (Appointment and Qualifications of Directors) Rule, 2014, Register of Directors and KMP with their Shareholding is to be maintained by every Company.
- According to which, the details of securities held by Directors and KMPs in the Company or its holding, subsidiary, subsidiary of company’s holding company or associate companies shall be disclosed/filled in with said Register.
ESOP – FAQ (1/2)

1) What is the difference between Employee Stock Option Plan (ESOP) and Employee Stock Purchase Scheme (ESPS)?

- In ESOP 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.

- ESPS 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. ESPS will be subject to lock-in-period of 1 year, the employee cannot sell the shares and/or the employee has to continue with the employer for a certain number of years. The company can offer shares to employees as part of a public issue.

2) What is the difference between ESOP and sweat equity share?

- Sweat Equity Shares are the shares given to the employee or directors at a discount or for consideration other than cash, for providing know-how / intellectual property rights. These are governed under section 54, read with Rule 8 of Chapter IV of Companies Act, 2013.

- ESOPs are the options granted to employees by the employer, which can be converted into Equity Shares on a future date, at a pre-determined price. These are governed by Section 62(1)(b), read with Rule 12 of Chapter IV of the Companies Act, 2013.
3) If any person has stock options, does it mean that he is the holder of the shares?

No the options are not like the owning of the shares, but it is only a right to buy the shares. He shall become shareholder only after the right is exercised in respect of those shares.

4) When does taxable event arise?

Taxable event doesn’t arise on granting options. It arises at the time of exercise of shares.

5) Whether shares under ESOP can be allotted in physical mode or it can only be allotted in electronic form?

A company may issue shares under the scheme in the physical form or in the electronic mode; therefore there is no restriction on the company to issue the shares in the electronic form only.

6) Can Company restrict transfer of shares issued pursuant to exercise of option?

Yes. Company has option to specify the lock in period at the time of granting.
HOW PEOPLE AND TAX ADVISORY @ BJAA WILL HELP
Employee Stock Option Plan (ESOP)

**ESOP IMPLEMENTATION AT BJAA**

- **Drafting ESOP Scheme**
  - Drafting ESOP agreement depending upon company’s requirement

- **Execution of Option Agreement**
  - Creating Option agreement and Executing

- **Accounting through the Exercise period**
  - Provide Accounting support and advise throughout the period

- **Facilitate on-going FEMA compliance**
  - Facilitate compliance with respect to FEMA in case of Foreign Employees

- **Facilitate on-going Companies Act compliance**
  - Facilitate on going compliance with respect to Companies Act, 2013 by Employers

- **Employee Communications**
  - Provide letters of Grant for employee communications for granting of options
WHY BANSHI JAIN AND ASSOCIATES (BJAA)?

1. Partners with over 30+ years of experience
2. Dedicated team of professionals with sound understanding and knowledge of the Act
3. Ready Checklists and Tool-kits due to on-going and continuous research on the law
4. Offering Host of Professional Services under one roof

Your preferred ESOP Advisory Partners
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About BJAA
Banshi Jain and Associates is a leading multi-disciplinary firm rendering focused professional services in areas of Assurance, Tax, Financial Advisory and Startup Advisory.
Banshi Jain and Associates (BJAA) is admired as a name of trust and excellence, with an aim to provide exceptional service delivery through value addition, client focus and innovative practices

Service Areas : Audit | Tax | Startups |Transactions | RERA | FEMA

BJAA has offices at : Mumbai, Jodhpur and Raipur. Find out more about us visit us at www.bjaa.in

About BJAA Startup Advisory
BJAA Startup | TAS is experienced team focused only on startups and plays an active hands-on role to support distinctive growth challenges these disruptive businesses face at every stage of their business lifecycle.

For more information, please contact Eshank M Shah at eshank.shah@bjaa.in / +91 9833113067

About BJAA Co-Learning
BJAA Co-Learning is a series of events, updates and shared learning experiences at the Firm and with Our Clients.

We disseminate accounting, tax and regulatory updates, on-the-job learnings and hold events to keep our team and clients apprised with the changing legislations.
APPENDIX
FOREIGN EMPLOYEE - EXIT

Foreign Employee

By the way of Sale/ Gift

Transfer to Resident in India

Transfer to Non Resident
(EXIT)
SALE BY NON RESIDENT INDIAN TO INDIAN RESIDENT
RESPONSIBILITY – NON RESIDENT

Foreign Resident (Seller)
- Section 195: Provide to buyer details required for computation of capital gain
- Capital Gain Tax Computation
- Whether shares are purchased in INR (Section 48) OR Foreign Currency (First proviso to Sec 48)

WITHOLDING TAX

Foreign Resident (Seller)
- Co-operate in executing Form FC-TRS for effecting transfer of shares

FILE FORM FC-TRS

Foreign Resident (Seller)
- Give Signatures to Applicable transfer Forms under Companies Act, 2013

VALUATION REPORT
**RESPONSIBILITY – RESIDENT**

**FEMA**

**Indian Resident (Buyer)**
- Automatic Route: No RBI Approval for Foreign Remittance of Funds
- Approval Route: RBI Approval for Foreign Remittance of Funds

**Indian Resident (Buyer)**
- File Form FC-TRS within 60 days of transfer of funds
- Documents required by AD branch while filing Form FC-TRS
  1. Consent Letter for the transfer of shares duly signed by Seller & Buyer.
  2. No objection/Tax Clearance Certificate from income Tax authority/CA
  3. Undertaking from buyer to effect that pricing guidelines have been adhered

**Indian Resident (Buyer)**
- Obtain Valuation Report from CA computing Fair Value per Share as per FEMA Guidelines on Valuation
- Exit price cannot be more than **Fair Value per share** as certified by a Chartered Accountant

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**RBI APPROVAL**

**FILE FORM FC-TRS**

**VALUATION REPORT**

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**Employee Stock Option Plan (ESOP)**
RESPONSIBILITY – TRANSFEROR (3/3)

FEMA and Companies Act

**Foreign Resident (Transferor)**
- No Reporting under FEMA and pricing can be as determined between the parties in compliance of FEMA and The Income Tax Act, 1961 (based on residency of the transferor)

**FEMA AND PRICING**

**Foreign Resident (Transferor)**
- Intimate company to give effect for change in shareholders

**CHANGE IN SHAREHOLDERS**
(EXIT)
SALE BY NON RESIDENT INDIAN TO
NON - INDIAN RESIDENT

Non-Resident Indian (Seller) --- Shares of Indian Company --- Non-Resident Indian (Buyer)
RESPONSIBILITY – TRANSFEROR (1/3)

Constitutes “indirect transfer” under Income Tax Act
**RESPONSIBILITY – TRANSFEROR (2/3)**

**Income Tax Act (TRANSFEROR / SELLER)**

1. **Indirect Transfer of Capital Asset**
   - In case of an “indirect transfer” capital gains tax is payable by the transferor as per Section 9(1) of Income Tax Act read with Section 2(14) and Section 2(47)

2. **Compute Capital Gains and pay tax liability**
   - Compute capital gains in hands of transferor as per Section 45 of Income Tax Act
   - Transferor to discharge Tax Liability in India (Obtain PAN and pay S.A Tax as assessed on Capital Gain)

3. **Check DTAA of India with Transferor**
   - Check DTAA between India and Transferor Country
   - Transferor may claim Tax Credit in Foreign Country for Tax Paid in India as per DTAA

4. **Claim DTAA Benefit**
   - For Claiming DTAA benefit: Form 10F, TRC PE Declaration and PAN Number is required

5. **Filing Form 15CA**
   - Non-resident making payment to a non-resident is required (transferor) to file Form 15CA