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Research

ESOPs and Other Benefits Plans for Employees in India

Legal, Regulatory and Tax Considerations

October 2023

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Introduction

One of the most popular employee reward and retention strategies used by global employers since decades has been Employee Stock Option Plans (**"ESOPs"**). ESOPs were invented in the USA in 1956 by a capitalist corporate lawyer Louis Kelso. They gained popularity in India since the late 1990s along with the advent of the technology sector in the country.

An ESOP is essentially a tool to attract, incentivize and retain talent in the company by offering to the employees an opportunity (known as an option) to purchase shares of the company at a future point in time or based on certain conditions, generally linked to time and/or performance. Ordinarily, the shares are offered at a pre-determined price which, as per the company's expectations, would be lower than the market price at the time when the employee will be eligible to exercise the option. The popular reasons for implementing ESOPs are wealth creation for employees, retention, attracting new talent and inculcating the feeling of employee ownership to motivate employees.

A survey conducted by KPMG in the year 2021 revealed that 68% of the 200 companies in India that participated in the survey have either implemented ESOPs or are contemplating to implement ESOPs plan.[1] ESOPs are prevalent among both Indian companies as well as foreign companies doing business in India. The main sectors which have implemented ESOPs are information, communication and entertainment (30%), followed by manufacturing and consumer goods (26%) and financial services and private equity (13%).[2] Further, an overwhelming 83% of companies surveyed prefer ESOPs linked to equity shares as the preferred security offered under ESOPs plan vis-à-vis other types of security such as warrants, debentures, preference shares or cash settled options.[3] 75% of companies surveyed have reported that they have uniform, i.e. non-discriminatory ESOPs for all employees irrespective of their level.[4] About 44% of the participants continue to prefer to implement conventional plain vanilla ESOPs over other more sophisticated variants.[5]

In recent years, the Government of India has also incentivized startups to implement ESOPs by granting various exemptions and relaxations. However, many early stage startups have failed to properly implement their ESOPs and provide their employees with adequate exit mechanisms due to external factors. This has adversely impacted the popularity of ESOPs among employees at Indian startups.

1 KPMG ESOP Survey Report 2021. The report is available here: https://kpmg.com/in/en/home/insights/2021/05/esop-survey-report-2021.html.

2 Ibid.

3 Ibid.

4 Ibid.

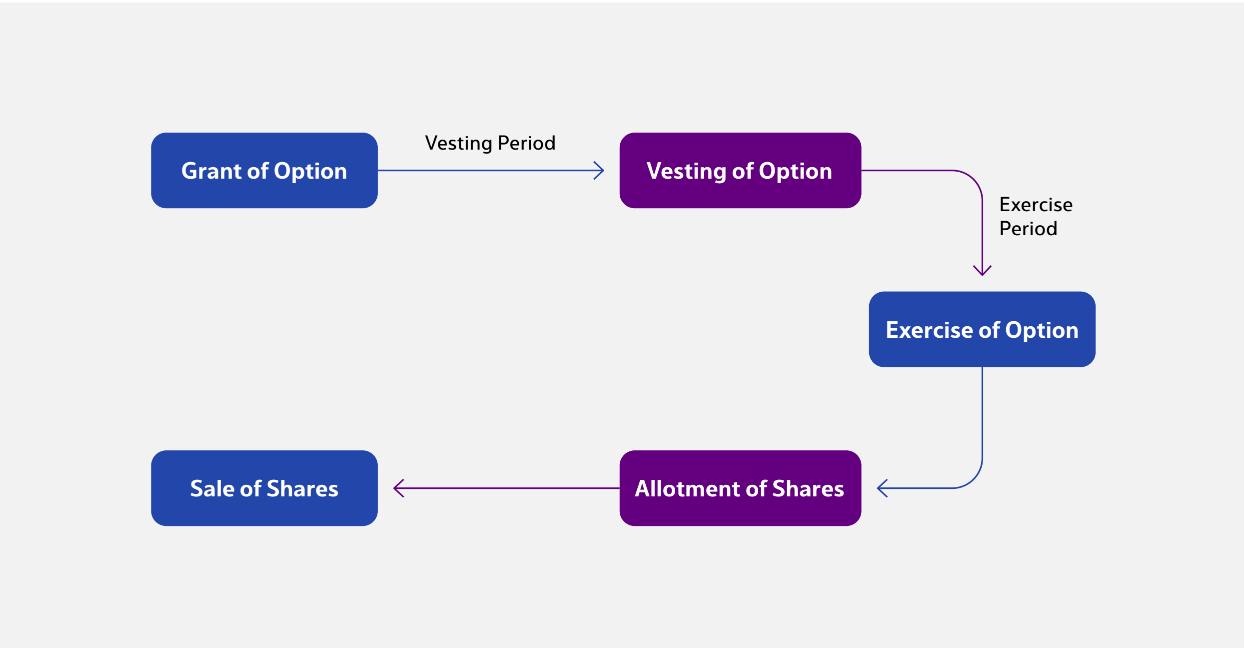
5 Ibid.

Mechanism of ESOP

By way of an ESOP, a company grants to an employee the right (option) to buy a certain number of shares of the company at a fixed price (exercise price) after a certain period[1] and/or based on certain performance parameters. Before the employee can exercise the option he is usually subject to a vesting period and may be required to fulfill vesting prerequisites, including continuous employment for a stipulated duration, achievement of performance targets, etc. After the vesting criteria are satisfied the options are said to be "vested".[2]

Once vested, the employee shall hold a right to "exercise" the option and be allotted shares of the company. Exercising an option essentially means the process by which a vested option is converted into shares by payment of the exercise price.[3] The shares received on exercise of the option generally rank *pari passu* with the other shares in the same class. The option holder is not entitled to either dividend or voting rights until he exercises the option and is allotted shares. If the company so wishes, it can in certain situations impose a lock-in on the shares and restrict the sale of shares pursuant to the exercise of the options.

Mechanism



1 Regulation 2(1) (p) of the SEBI (Share Based Employee Benefits) Regulations, 2021 defines a "grant" to mean the process by which the company issue options, SARs, shares, or any other benefits to employees under the ESOP.

2 Regulation 2(1) (xx) of the SEBI (Share Based Employee Benefits) Regulations, 2021 defines "vesting" to mean the process by which an employee is given the right to apply for shares of the company against the option granted to him in pursuance of ESOP.

3 Regulation 2(1) (l) of the SEBI (Share Based Employee Benefits) Regulations, 2021 defines "exercise" means making of anapplication by the employee to the company for issue of shares or appreciation in form of cash, as the case may be, against vested options or vested SARs in pursuance of ESOP and Stock Appreciation Rights Scheme.

Types of ESOPs

ESOPs may be of different types, as listed below:

i. **Employee Stock Option Scheme** (“**ESOS**”): An employee stock option is a grant of an option to receive shares of the company at a future date at a predetermined price. This may be a paid incentive or a cashless option. ESOS is the most traditional ESOP structure globally.

ii. **Employee Stock Purchase Scheme** (“**ESPS**”): Ordinarily company-run programs, wherein participating employees are provided the option to purchase company shares at a discounted price. Employee’s contributions are made through payroll deductions between the grant date and the exercise date. ESPS is also known as Employee Share Purchase Plan (“**ESPP**”).

iii. **Restricted Stock Units** (“**RSUs**”): An RSU is a grant valued in terms of the company’s shares, and the issue of shares is subject to restrictions such as attainment of the company’s financial targets, employee performance, etc.

iv. **Restricted Share Plan**: Under a restricted share plan, the employee has the option to acquire a certain number of shares immediately, subject however to certain restrictions on those shares.

v. “**Save As You Earn**” **Share Schemes** (“**SAYE**”): SAYE also known as Sharesave is an employee’s savings scheme where an employee is given the option to purchase shares of the company at a discount by investing a percentage of their monthly salary in a savings account.

vi. **Employee Share Awards Plan** (“**ESAP**”): Unlike ESPS, an ESAP allows the employee to directly purchase shares of the company instead of being granted stock options.

vii. **Incentive Stock Options** (“**ISOs**”): An ISO is a type of statutory stock option used in USA where an employer gives employees an opportunity to purchase stock at a fixed price during a specified time. The term of these options is statutorily fixed, i.e., such period cannot exceed 10 years and the exercise price must be equal or more than the value of the stock at the time of grant, and options for no more than $100,000 worth of stock (determined at time of grant) may become exercisable in any year.

viii. **Non-qualified stock options** (“**NSOs**”): The NSO is a type of ESOP scheme used in USA which involves an offer by an employer to sell its stock to an employee for a specified price at any time during a specified period. In exercising stock options, an employee incurs a tax liability equal to the difference between the market and exercise price that is reported as wages.

ix. **Company Share Option Plan** (“**CSOP**”): CSOP is a type of ESOP scheme used in the UK where employees and directors who hold less than 30% of the company can be granted stock options at a pre-determined price to be exercised at a future date.

x. **Enterprise Management Initiatives** (“**EMI**”): EMI is a type of ESOP scheme used by small companies in the UK whose gross assets do not exceed £30 million; are not controlled by another company; and operate in certain notified sectors. There is no limit on the number of participants to this type of scheme if the maximum value of the options does not exceed £3 million in aggregate.

xi. **Share Incentive Plan** (“**SIP**”): A SIP is a tax-advantaged ESOP used in the UK under which shares are held by a special employee benefit trust on behalf of the employee. Under SIP, companies may structure four different types of share award depending on the intended beneficiaries: free shares, partnership shares; matching shares and dividend shares.

xii. **Bons de souscription de parts de créateurs d’entreprise** (“**BSPCE**”): These are warrants commonly used in France giving the holder the right to subscribe to newly issued shares at a specific future date for a fixed price.

xiii. **Company savings plan** (**plan d'épargne entreprise**) ("**PEE**"): A PEE is a form of collective voluntary savings scheme used in France that allows employees to participate in a portfolio of securities (including sometimes shares of the employer group companies), and that is eligible for a specific tax and social security regime.

xiv. **French-qualified shares awards**: Plans for the grant of shares for no consideration to be paid by the employee, also called conditional shares awards, which can be presence or performance-based.

xv. **Employee participation certificates/ employee share certificates** ("**EPC**")/("**ESC**"): These are instruments whose economic purpose is like that of an ESOP. Essentially, companies incentivize employees by issuing bonds which provide profit-based interest. These certificates are especially suitable for unlisted companies.

xvi. **Sweat Equity**: Although similar to ESOPs, sweat equity is a conceptually different mechanism. It seeks to reward employees or directors for providing / transferring specific technical know-how or IPRs to the company by issuing them shares free of charge or at a discount.

In India, ESOS continues to be the most common. There could also be monetary benefits linked to the shares or securities of a company, such as:

i. **Stock Appreciation Rights** ("**SARs**"): SARs are performance based incentives that are linked to the performance of the company and assessed in terms of the company's share value. At the time of exercising the option, the company may issue shares or cash equivalent of the shares.

ii. **Phantom Stock Options** ("**PSOs**"): SARs which provide for cash based payouts are referred to as PSOs. These do not involve the purchase or sale of shares and are purely cash based. In certain jurisdictions, such as Germany, PSOs are also referred to as virtual stock options.

Applicable Laws

Issue of ESOPs by an Indian company is primarily governed by:

i. The Companies Act, 2013 (“**Companies Act**”), which defines an ‘employee stock option’ to mean an option given to the directors, officers or employees of a company or of its holding company or subsidiary company, which give them the benefit or right to purchase or subscribe at future date, the securities offered by the company at predetermined price.[1] The Companies Act must be read with the relevant allied rules including *inter alia* The Companies (Share Capital and Debenture) Rules, 2014 (“**SCDR**”) which regulates ESOPs issued by unlisted and private companies.

ii. The Securities and Exchange Board of India (Share Based Employee Benefits and Sweat Equity) Regulations, 2021[2] (“**ESOP Regulations**”), which provides guidance with respect to granting various types of ESOPs and other specific benefits to certain categories of employees.[3] The ESOP Regulations are applicable to a company whose shares are listed on any recognised stock exchange in India[4] and has an ESOP Scheme as envisaged under these regulations.[5]

iii. The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 (“**ICDR**”).

iv. The regulations issued by the Reserve Bank of India (“**RBI**”) under the Foreign Exchange Management Act, 1999 (“**FEMA**”) on ESOPs and issue of Indian securities to non-Indian employees and foreign securities to Indian employees.

v. The Income Tax Act, 1961 (“**ITA**”) and the rules issued there under.[6]

1 Section 2(37) of the Companies Act, 2013.

2 On August 13, 2021 SEBI issued the SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 repealing the SEBI (Share Based Employee Benefits) Regulation 2014 and the SEBI (Issue of Sweat Equity) Regulations, 2002.

3 Regulation 1(3), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

4 Under the Securities Contracts (Regulation) Act, 1956 (SCRA), a ‘recognized stock exchange’ has been defined as a stock exchange which is, for the time being, recognized by the Government of India as per the provisions of SCRA.

5 Regulation 1(4), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

6 Section 115WC of the IT Act defines an “option” to mean a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price.

ESOPs by Indian Listed Companies

Until the late 1990s, ESOPs were largely unregulated in India. In response to the mounting popularity of using ESOPs as a tool of recruiting and retaining talent largely in the information technology (IT) and related sectors, the Securities and Exchange Board of India ("**SEBI**") formulated the SEBI Guidelines, which came into force in June 1999. Subsequently, spurred by the promulgation of Companies Act and recognizing the growing need to regulate more sophisticated variants of ESOPs issued by Indian companies, SEBI formulated the ESOP Regulations in 2014 thereby repealing the erstwhile SEBI Guidelines.

The extant ESOP Regulations are applicable to issuance of ESOPs, ESPS, SARs, General Employee Benefit Schemes ("**GEBS**") and Retirement Benefit Schemes ("**RBS**") by companies whose shares are listed on a recognised stock exchange in India.[1] It is important to note that at present the ESOP Regulations do not regulate or apply to PSOs/ cash-settled SARs.[2] The ESOP Regulations also need to be complied with by unlisted companies in cases where options/ SARs are proposed to be issued under an existing ESOP after listing of the shares of the company.

The key considerations and restrictions stipulated under the ESOP Regulations are as follows:

I. Eligibility to Participate

- All permanent employees (including those of a subsidiary or holding company) except an employee who is a promoter[3] or belongs to the promoter group,[4] and all non-independent directors including

1 Regulation 1(3), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

2 Informal Guidance Note dated July 27, 2015 issued by SEBI in response to a request for informal guidance sought by Mindtree Limited in relation to (among others) the applicability of the SEBI Employee Benefit Regulation to a proposed Phantom Stock Scheme read with the Informal Guidance Note dated July 24, 2015 issued by SEBI in response to a request for informal guidance sought by Saregama India Limited.

3 Regulation 2(1) (cc), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 defines a 'promoter' to mean a person:

i) who has been named as such in a draft offer document or offer document or is identified by the issuer in the annual return referred to in section 92 of the Companies Act, 2013; or

ii) who has control over the affairs of the issuer, directly or indirectly whether as a shareholder, director or otherwise; or

iii) in accordance with whose advice, directions or instructions the board of directors of the issuer is accustomed to act:

Provided that nothing in sub-clause (iii) shall apply to a person who is acting merely in a professional capacity;

Provided further that a financial institution, scheduled commercial bank, foreign portfolio investor other than Category III foreign portfolio investor, mutual fund, venture capital fund, alternative investment fund, foreign venture capital investor, insurance company registered with the Insurance Regulatory and Development Authority of India or any other category as specified by the Board from time to time, shall not be deemed to be a promoter merely by virtue of the fact that twenty per cent. or more of the equity share capital of the issuer is held by such person unless such person satisfy other requirements prescribed under these regulations.

4 Regulation 2(1) (dd), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 defines "promoter group" to include:

i) the promoter;

ii) an immediate relative of the promoter (i.e. any spouse of that person, or any parent, brother, sister or child of the person or of the spouse); and

iii) in case promoter is a body corporate:

a) a subsidiary or holding company of such body corporate;

b) any body corporate in which the promoter holds twenty per cent. or more of the equity share capital; and/or any body corporate which holds twenty per cent. or more of the equity share capital of the promoter;

c) any body corporate in which a group of individuals or companies or combinations thereof acting in concert, which hold twenty per cent. or more of the equity share capital in that body corporate and such group of individuals or companies or combinations thereof also holds twenty per cent. or more of the equity share capital of the issuer and are also acting in concert; and

iv) in case the promoter is an individual:

a) any body corporate in which twenty per cent. or more of the equity share capital is held by the promoter or an immediate relative of the promoter or a firm or Hindu Undivided Family in which the promoter or any one or more of their relative is a member;

b) any body corporate in which a body corporate as provided in (A) above holds twenty per cent. or more, of the equity share capital; and

c) any Hindu Undivided Family or firm in which the aggregate share of the promoter and their relatives is equal to or more than twenty per cent of the total capital.

v) all persons whose shareholding is aggregated under the heading "shareholding of the promoter group":

Provided that a financial institution, scheduled bank, foreign portfolio investor other than Category III foreign portfolio investor, mutual fund, non-executive directors, are eligible to participate[5] in the ESOP of the company subject to approval by the compensation committee.[6] The definition of 'employee' under ESOP Regulation does not distinguish between permanent and non-permanent employees. The ESOP Regulations considers employees from a group company including subsidiary or its associate company or from a holding company, as an employee except for promoters and directors who directly or indirectly hold more than ten per cent of the outstanding equity shares of the company.

- A director who either by himself or through his relative or through any body corporate, directly or indirectly holds more than 10% of the outstanding equity shares of the company is not eligible to participate in the ESOP.[7]

II. Compensation Committee

- The company is required to constitute a Compensation Committee for administration of the ESOP.[8]
- The Compensation Committee must consist of 3 or more non-executive directors from the board of directors of which at least 50% must be independent directors.[9]
- The Compensation Committee is responsible for formulating the detailed terms and conditions of the ESOP[10] and ensuring that there is no violation of SEBI (Insider Trading) Regulations, 2015 and SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 2003.[11]

III. Shareholder Approval

- ESOPs cannot be offered to employees of a company unless the shareholders of the company approve the scheme by passing a special resolution in a general meeting.[12]

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venture capital fund, alternative investment fund, foreign venture capital investor, insurance company registered with the Insurance Regulatory and Development Authority of India or any other category as specified by the Board from time to time, shall not be deemed to be promoter group merely by virtue of the fact that twenty per cent. or more of the equity share capital of the promoter is held by such person or entity:

Provided further that such financial institution, scheduled bank, foreign portfolio investor other than Category III foreign portfolio investor, mutual fund, venture capital fund, alternative investment fund and foreign venture capital investor insurance company registered with the Insurance Regulatory and Development Authority of India or any other category as specified by the Board from time to time shall be treated as promoter group for the subsidiaries or companies promoted by them or for the mutual fund sponsored by them.

5 Regulation 2(1) (i), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 defines 'employee' for the purposes of regulation to mean:

i) an employee as designated by the company, who is exclusively working in India or outside India; or

ii) a director of the company, whether a whole time director or not, including a non-executive director who is not a promoter or member of the promoter group, but excluding an independent director; or

iii) an employee as defined in sub-clauses (i) or (ii), of a group company including subsidiary or its associate company, in India or outside India, or of a holding company of the company, but does not include—

a) an employee who is a promoter or a person belonging to the promoter group; or

b) a director who, either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten per cent of the outstanding equity shares of the company.

6 Regulation 4, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

7 Regulation 2(1) (i) (iii) (b), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

8 Regulation 5(1), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

9 Regulation 5(2), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 read with Section 178 Companies Act, 2013.

10 Regulation 5(3), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

11 Regulation 5(4), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

12 Regulation 6(1), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

- The approval of shareholders by way of separate resolution in the general meeting is to be obtained by the company in case of:[13]
  - secondary acquisition for implementation of the schemes;
  - secondary acquisition by the trust in case share capital expands due to capital expansion;
  - grant of option/ SAR or other benefits to employees of subsidiary or holding company; and
  - grant of option/ SAR or other benefits to identified employees, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option/ SAR or other benefits.

IV. Pricing

- The company has the freedom to determine the exercise price of shares or options subject to conforming to the prescribed accounting policies.[14]

V. Lock-in Period

- There shall be a minimum vesting period of one year.[15]
- The company has the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.[16]
- An employee shall not have the right to receive any dividend, to vote or in any manner enjoy the benefits of being a shareholder in respect of option granted, till such shares are issued on exercise of the option.[17]

VI. Transferability of an Option

- Stock options, SARs and any other benefit granted to an employee are non-transferrable.[18]
- Stock options, SARs and any other benefit granted to an employee cannot be pledged, hypothecated, mortgaged or otherwise alienated in any other manner.[19]
- In the event of the death of an employee while in employment, all options, SARs and any other benefit granted shall vest in the legal heirs or nominees of the deceased employee.[20]
- In case the employee suffers a permanent incapacity while in employment, all options, SARs and any other benefits granted as on the date of permanent incapacitation, shall vest on that day.[21]
- In the event of resignation or termination of the employee, all un-vested options, SAR and any other benefits as on the date of resignation/termination shall expire.[22] The treatment of resignation or termination of an employee shall be different to that from cessation of employment due to retirement or superannuation.

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13 Regulation 6(3), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

14 Regulation 17, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

15 Regulation 18(1), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

16 Regulation 18(2), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

17 Regulation 19, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

18 Regulation 9(1), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

19 Regulation 9(3), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

20 Regulation 9(4), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

21 Regulation 9(5), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

22 Regulation 9(6), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

This means that in the event of retirement of superannuation of an employees, any benefits granted to an employee under ESOP Regulations, which have not vested, will not expire, and will continue to vest according to the applicable policy.[23]

- In the event that an employee who has been granted options, SARs and any other benefits is transferred or deputed to an associate company prior to vesting/ exercise, such vesting/exercise shall continue even after the employee is transferred/ deputed.[24]
- In the event that an employee who has been granted benefits under a scheme, is transferred pursuant to scheme of arrangement, amalgamation, merger or demerger or continued in the existing company, prior to the vesting or exercise, the treatment of options in such case shall be specified in such scheme of arrangement, amalgamation, merger or demerger provided that such treatment shall not be prejudicial to the interest of the employee.[25]

Please note that contrary to previous regulations which only allowed the company to fund the payment of exercise price, now the company or the trustee can fund or allow the empanelled stockbrokers to fund the employee's tax obligations and other related expenses pursuant to exercise of options granted under the Employee Stock Option Schemes or Stock Appreciation Rights.[26]

VII. Variation of Terms of the ESOP

- The terms of the ESOP can be changed by the company by way of a special resolution, provided that the employees have not exercised their rights under the earlier scheme and the variations in deliberation are not detrimental to the employees' interest. However, such variations will not require approval by way of a special resolution if the changes are made in order to comply with regulatory requirements.[27]
- The company may by special resolution in a general meeting vary the terms of ESOP offered pursuant to an earlier resolution of a general body but not yet exercised by the employee provided such variation is not prejudicial to the interests of the employee.[28] Notice for passing such special resolution shall disclose full details of the proposed variation along with the rationale and details of the beneficiaries of the same.[29]
- The price of the options that have not been exercised may be varied, whether or not they have been vested, if the option is rendered unattractive due to fall in the price of the shares in the market provided that such repricing is not detrimental to the interest of the employees and subject to shareholder approval in general meeting.[30]

23 Explanation to proviso to Regulation 9(6), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

24 Regulation 9(7), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

25 Regulation 9(8), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

26 Proviso to Regulation 9(2), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

27 Regulation 7(1), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

28 Regulation 7(2), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

29 Regulation 7(4), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

30 Regulation 7(5), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

VIII. Issuance of ESOP Through Trust Route

Shareholder Approval

- A company may implement an ESOP either directly or by setting up an irrevocable trust and such decision shall be decided upfront at the time of taking shareholder approval. In case the ESOP involves secondary acquisition or gift or both, issuance through trust route is mandatory.[31]

Maintenance of Records

- A company may use a single trust to implement multiple ESOPs if such trust always maintains proper records, books of account and documents for each ESOP.[32]

Eligibility for Role of Trustee

- A person shall not eligible to be appointed as a trustee if he:
  - is a director, key managerial personnel or promoter of the company or its holding, subsidiary or associate company or any relative of such director, key managerial personnel or promoter; or
  - beneficially holds ten percent or more of the paid-up share capital of the company.
- In case individuals or one person companies are appointed as trustees, there shall be a minimum of two such trustees and in case a corporate entity is appointed as a trustee, it may be a sole trustee.
- Trustees shall ensure that appropriate shareholder approvals have been obtained by the company to enable the trust to implement the schemes and undertake secondary acquisition for the purposes of the scheme.

Restrictions

- The trust shall not deal in derivatives, and shall undertake only delivery based transactions for the purposes of secondary acquisition as permitted.
- In disclosures made to the stock exchange, shareholding of the trust shall be shown as 'non-promoter and non-public' shareholding.[33]
- Total number of shares under secondary acquisition held by the trust shall at no time exceed the following limits as a percentage of paid-up equity capital as at the end of the financial year immediately prior to the year in which shareholder approval is obtained for such secondary acquisition:

Particulars	Limit
For ESOS, ESPS and SARs	5%
For GEBS, RBS	2%
For all schemes in aggregate	5%

  - The above limits shall automatically include within their ambit the expanded capital of the company where such expansion has taken place on account of corporate action including issue of bonus shares, split or rights issue.

31 Regulation 3(1), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

32 Regulation 3(2), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

33 Public shareholding needs to be maintained at a minimum of twenty-five percent as prescribed under Securities Contracts (Regulations) Rules, 1957.

  - If a company has multiple trusts and schemes, the aforesaid ceiling limit shall be applicable for all such trusts and schemes taken together at the company level and not at the level of individual trust or scheme.
  - The above ceiling limit will not be applicable where shares are allotted to the trust by way of new issue or gift from promoter or promoter group or other shareholders.
  - In the event that the options, shares or SAR granted under any of the schemes exceeds the number of shares that the trust may acquire through secondary acquisition, then such shortfall of shares shall be made up by the company through new issue of shares to the trust in accordance with the provisions of new issue of shares under the applicable laws.
- The trust may undertake off-market transfer of shares only in case of a) transfer to the employees pursuant to scheme; b) when participating in an open offer under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, or when participating in buy-back, delisting or any other exit offered by the company generally to its shareholders.
- The trust is required to hold shares acquired through secondary acquisition for a minimum period of six months except when they are required to be transferred on account of when participating in an open offer under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, or when participating in buy-back, delisting or any other exit offered by the company generally to its shareholders.
- The trust is also restricted from selling shares in the secondary market except in case of:
  - cashless exercise of options under ESOS;
  - on vesting or exercise of appreciation rights under SARS;
  - in case of emergency for implementing the schemes under RBS and GEBS subject to the record of reasons for such sale by the trustees and money so realised on sale of shares shall be utilised within a definite time period as stipulated under the scheme or trust deed;
  - participation in buy-back or open offers or delisting offers or any other exit offered by the company generally to its shareholders, if required;
  - for repaying the loan, if the un-appropriated inventory of shares held by the trust is not appropriated within the prescribed timeline;
  - winding up of the scheme(s); and
  - based on approval granted by SEBI to an applicant, for the reasons recorded in writing in respect of ESOS, ESPS and SARS upon payment of a non-refundable fee of rupees 1 lakh along with the application.

IX. Failure to Exercise Option

- The amount payable by the employee, if any, at the time of grant of option may be forfeited by the company if the option is not exercised by the employee within the exercise period. Alternatively, the amount may be refunded to the employee if the option is not vested due to non-fulfillment of condition relating to vesting of option as per the ESOP.[34]

34 Regulation 20, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

ESOPs by Indian Unlisted and Private Companies

The key considerations and restrictions stipulated under the SCDR are as follows:

I. Eligibility to Participate

- All permanent employees (including those of a subsidiary or holding company) except an employee who is a promoter or belongs to the promoter group, and all non-independent directors, are eligible to participate in the ESOP of the company subject to approval by the compensation committee.
- A director who either by himself or through his relative or through any body corporate, directly or indirectly holds more than 10% of the outstanding equity shares of the company is not eligible to participate in the ESOP.[1]

II. Shareholder Approval

- Stock options cannot be offered to employees of a company unless the shareholders of the company approve the scheme by passing a special resolution in a general meeting.[2] The company shall make prescribed disclosures in the explanatory statement annexed to the notice for passing of the special resolution.[3]
- The approval of shareholders by way of separate resolution in the general meeting is to be obtained by the company in case of:
  - grant of option to employees of subsidiary or holding company; and
  - grant of option to identified employees, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.[4]

III. Pricing

- The company has the freedom to determine the exercise price subject to conforming to the prescribed accounting policies.[5]

IV. Lock-in Period

- The SEBI Guidelines mandate a minimum period of one year between the grant of options and vesting of option.[6]
- In case where options are granted by a company under its ESOP in lieu of options held by the same employee under an ESOP in another company which has merged/ amalgamated with the aforementioned company, the period during which the options granted by the merging/ amalgamating company were held by him shall be adjusted against the minimum vesting period of ESOP of the acquiring company.[7]

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1 Regulation 12(1), Companies (Share Capital and Debenture) Rules, 2014.

2 Regulation 12(1), Companies (Share Capital and Debenture) Rules, 2014.

3 Regulation 12(2), Companies (Share Capital and Debenture) Rules, 2014.

4 Regulation 12(4), Companies (Share Capital and Debenture) Rules, 2014.

5 Regulation 12(3), Companies (Share Capital and Debenture) Rules, 2014.

6 Regulation 12(6), Companies (Share Capital and Debenture) Rules, 2014.

7 Regulation 12(6), Companies (Share Capital and Debenture) Rules, 2014.

- The company has the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.
- An employee shall not have the right to receive any dividend, to vote or in any manner enjoy the benefits of being a shareholder in respect of option granted, till such shares are issued on exercise of the option.[8]

V. Transferability of an Option

- Stock options granted to an employee are non-transferrable.
- Stock options cannot be pledged, hypothecated, mortgaged or otherwise alienated in any other manner.
- In the event of the death of an employee while in employment, all options granted shall vest in the legal heirs or nominees of the deceased employee.
- In case the employee suffers a permanent incapacity while in employment, all options granted as on the date of permanent incapacitation, shall vest on that day.
- In the event of resignation or termination of the employee, all un-vested options as on the date of resignation/termination shall expire.[9]

VI. Variation of Terms of the ESOP

- The company may by special resolution in a general meeting vary the terms of ESOP offered pursuant to an earlier resolution of a general body but not yet exercised by the employee provided such variation is not prejudicial to the interests of the employee. Notice for passing such special resolution shall disclose full details of the proposed variation along with the rationale and details of the beneficiaries of the same.[10]

VII. Failure to Exercise Option

- The amount payable by the employee, if any, at the time of grant of option may be forfeited by the company if the option is not exercised by the employee within the exercise period. Alternatively, the amount may be refunded to the employee if the option is not vested due to non-fulfillment of condition relating to vesting of option as per the ESOP.[11]

8 Regulation 12(6), Companies (Share Capital and Debenture) Rules, 2014.

9 Regulation 12(8), Companies (Share Capital and Debenture) Rules, 2014.

10 Regulation 12(5), Companies (Share Capital and Debenture) Rules, 2014.

11 Regulation 12(7), Companies (Share Capital and Debenture) Rules, 2014.

Sweat Equity

I. Unlisted Companies

In case of unlisted companies, issue of sweat equity is regulated by the Companies Act and the SCDR. In case of listed companies, ESOP Regulations are applicable. Sweat equity shares are defined as equity shares, which are issued by a Company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

The key considerations and restrictions stipulated under the SCDR for private unlisted companies are as follows:

Eligibility

- Permanent employees of the Company who have been working in India or outside India for a minimum period of 1 year;
- Directors (whether whole time or not);
- an employee or director of a subsidiary or of a holding company.

Approvals

- Prior shareholder approval required through special resolution.

Restrictions

- Mandatory lock-in for a period of 3 years from date of allotment.
- Quantum of sweat equity issued in a particular year shall not exceed 15% of existing paid up equity share capital or Rs. 5,00,00,000 (whichever is higher).
- Quantum of sweat equity issued must not exceed 25% of paid up equity capital of the Company at any time.

II. Listed Companies

The ESOP Regulations provides that an unlisted company coming out with initial public offer and seeking listing of its securities on the recognized stock exchange, pursuant to issue of sweat equity shares, shall comply with the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirement) Regulations, 2018.[1]

The key considerations and restrictions stipulated under the ESOP Regulations for private listed companies are as follows:

Eligibility

- An employee of the company working in India or abroad;
- or a director of the company whether a whole time director or not are eligible for issue of sweat equity shares.[2]

Approval

Each issue of sweat equity shares shall be voted by a separate resolution.[3]

Issue of Sweat Equity Shares to Employees who Belong to Promoter or Promoter Group

The issue of sweat equity shares to employees who belong to promoter or promoter group shall be approved by way of a resolution passed by a simple majority of the shareholders in general meeting. For passing such a resolution, voting through postal ballot and/or e-voting as specified under Companies (Management and Administration) Rules, 2014 shall also be adopted. The promoters/promoter group should not participate in such resolution.[4]

Restrictions

The ESOP Regulations has introduced a 15% annual limit on listed companies for issuance of sweat equity shares out of paid-up equity share capital with an overall limit of 25% on paid capital equity share capital at any point of time. However, for companies listed on the Innovators Growth Platform, the annual limit shall be 15% with an overall limit of 50% of the paid-up capital applicable till 10 years from the company's date of incorporation or registration.[5]

1 Regulation 28, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

2 Regulation 29, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

3 Regulation 32(3), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

4 Regulation 32(2), SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

5 Regulation 31, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

Pricing of Sweat Equity Shares

The pricing system to be followed for sweat equity shares is the same as the system stipulated in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, for preferential issue to a person other than a qualified institutional buyer. This is a significant departure form the pricing system applicable to issue of sweat equity shares under Regulation 7 of the ISE Regulations.[6]

Ceiling on Managerial Remuneration

The amount of sweat equity shares issued shall be treated as part of managerial remuneration, if the following conditions are fulfilled:[7]

i. the sweat equity shares are issued to any director or manager; and

ii. the sweat equity shares are issued for non-cash consideration, which does not take the form of an asset which can be carried to the balance sheet of the company in accordance with the relevant accounting standards.

Lock-in Period of Equity Shares

The lock-in will be same as lock-in requirement applicable to preferential issues under Regulation 167 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, depending on whether the shares have been issued to promoters or employees. Under the ESOP Regulations, sweat equity shares issued to the promoter or promoter group shall be locked-in for a period of three years. However, sweat equity shares issued to the promoter or the promoter group in excess of twenty per cent of the total capital of the issuer shall be locked-in for a period of one year only.

For employees other than the promoters or the promoters group, the sweat equity shares shall be locked-in for a period of one year.[8]

6 Regulation 33, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

7 Regulation 37, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

8 Regulation 38, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021.

ESOPs and Sweat Equity by Indian Startups

Startup India launched in 2016 is an initiative by the Government of India under the aegis of the Make in India campaign. One of the main objectives of this initiative is to facilitate fund raising by reducing bottlenecks and regulatory compliances for startups.[1] Accordingly, the following relaxations have been provided exclusively to startups:

I. Issue of Sweat Equity

Previously, a startup was prohibited from issuing sweat equity shares beyond 25% of its paid-up capital. Now, a startup is permitted to issue sweat equity shares to its employees or directors to the tune of 50% of its paid-up capital upto 7 years from its date of incorporation. However, startups are not permitted to issue sweat equity exceeding 15% of the existing paid-up equity share capital in a year or shares of the issue value of rupees five crores, whichever is higher. Moreover, an earlier restriction[2] prohibiting startups from issuing sweat equity within the first year since commencement of business has also been removed, thereby allowing a startup to issue sweat equity in its maiden year itself.

II. Issue of ESOPs

Previously, ESOPs could not be issued to employees who belonged to the promoter group and directors who directly or indirectly held more than 10% of the outstanding equity shares of the company. Now, these restrictions have been removed and employees belonging to the promoter group and directors holding more than 10% equity shares in the company are also eligible to receive ESOPs. However, this relaxation applies only to those promoters who are either employees/ directors of the company and passive promoters are not eligible to receive ESOPs.

It is important to note that all other extant conditions and restrictions for issuing ESOPs and sweat equity shares continue to apply *mutatis mutandis* to all startups notwithstanding the abovementioned relaxations.

1 As per DIPP Notification G.S.R. 364(E) dated 11th April, 2018, "startup" has been defined as an entity that is incorporated or registered in India. Furthermore, the department said an entity will be considered a startup:

- Up to a period of seven years from the date of incorporation/registration. For biotechnology firms, that period is ten years.
- Provided it has an annual turnover not exceeding Rs 25 crore in any preceding financial year, and.
- If it works towards innovation, development or improvement of products or processes or services, or if it's a scalable business model with a high potential of employment generation or wealth creation.

2 Section 54, Companies Act 2013.

Employment Law Implications

Employment statutes in India are social welfare legislations and have been enacted with the intention of protecting employee interests. While implementing an ESOP, a company should bear the following employment law obligations in mind:

I. Unfair Labour Practices and Discriminatory Practices

The Industrial Disputes Act, 1947 ("**ID Act**"),[1] one of the key enactments governing employer-employee relationships and mechanisms for resolving industrial disputes categorically prohibits an employer from engaging in any unfair labour practice, including but not limited to, showing favouritism or partiality to a set of workers regardless of merit.

While India has not seen such cases previously, if the options are granted arbitrarily, the practice may be challenged by either a trade union or the employees on the grounds of adopting discriminatory practices, victimization or partiality between similarly situated employees. It is therefore prudent for a company to lay down the objective criteria under which an eligible employee will be entitled to benefits of the ESOP.

II. Acquired rights

It should be ensured by executing appropriate documentation that employees who are granted benefits under any ESOP cannot claim guaranteed rights to continue receiving benefits after the ESOP has ceased or in relation to continued employment with the employer.

III. Severance

Care should be taken to ensure that stock options do not form part of the employee's salary / wages else the value of stock options may need to be taken into consideration at the time of calculation of notice pay, severance and gratuity, payable under applicable labour laws.

1 The ID Act, applies only to a "workman" i.e. a person employed in any industry to do any manual, unskilled, skilled, technical, clerical or supervisory work for hire or consideration, excluding employees mainly engaged in a managerial or administrative capacity, those in supervisory capacities who draw a monthly salary of more than Rs 10,000, or those in the armed or police forces.

Securities Law Implications

I. Initial Public Offer Restrictions

An Initial Public Offer (IPO) is one of the biggest events in the lifecycle of a listed company. IPOs are regulated by various statutes including *inter alia* the SEBI ICDR Regulations which mandates certain eligibility conditions required to be complied with by the issuer prior to an IPO. One such condition disallows an issuer from undertaking an IPO if there are any outstanding convertible securities or any right entitling any person with an option to receive equity shares of the issuer.[1]

The ICDR Regulations also grant the issuer certain exceptions from the aforementioned eligibility conditions including *inter alia* any outstanding option "granted to employees" pursuant to an employee stock option scheme.[2] Accordingly, stock options granted pursuant to an ESOP can remain outstanding at the time of undertaking an IPO. This exemption is critical since ESOPs are generally issued to a large number of employees and the onerous obligation of constantly monitoring, controlling or restricting the use of these options will pose significant logistical challenges to the issuer and may adversely delay the IPO.

II. Insider Trading Restrictions

The SEBI (Prohibition of Insider Trading) Regulations, 2015 restricts an "insider" from trading in securities of the company while in possession of unpublished price sensitive information ("**UPSI**").[3] "Insider" includes *inter alia* directors, officers and employees of the company.[4] As per the definition, UPSI refers to any information relating to a company or its securities, directly or indirectly that is not generally available which upon becoming available is likely to materially affect the price of securities[5] and includes *inter alia* any information relating to financial results; dividends; change in capital structure; corporate restructuring activities; changes in key managerial personnel; and material events as per the Listing Agreement.

Therefore, ESOP holders are not permitted to trade in securities while in possession of any UPSI as the Compliance Officer of the company declares closure of trading window for such designated employees while any transaction involving UPSI is under consideration.[6]

The restriction imposed by the regulations combined with the frequency of UPSI events may significantly lower the window of time available for an ESOP holder to exercise his option or to sell his shares.

1 Regulation 26(5), SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

2 Regulation 26(5) (b), SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. For the purposes of this exception, "employee" includes a permanent and full time employee of the issuer or of the holding company or subsidiary company or of that material associate(s) of the issuer.

3 Regulation 4(1), SEBI (Prohibition of Insider Trading) Regulations, 2015.

4 Regulation 2(g), SEBI (Prohibition of Insider Trading) Regulations, 2015.

5 Regulation 2(g), SEBI (Prohibition of Insider Trading) Regulations, 2015.

6 Regulation 5, SEBI (Prohibition of Insider Trading) Regulations, 2015.

Exchange Control Implications — Cross Border ESOPs

Indian exchange control laws regulate the acquisition and disposal of any non-Indian security by resident Indian individuals and issue of shares by an Indian company to entities outside India.

I. Issue of ESOPs by Foreign Companies to Employees in India

Cross border stock option plans enable employees of Indian companies to participate in the global stock option plans of their parent company or any other foreign company in the same group. The Foreign Exchange Management (Overseas Investment) Rules, 2022 ("OI Rules") permit a resident individual to acquire, without limit, shares or interest under ESOP or employee benefits scheme or sweat equity shares[1] offered by the overseas entity subject to the following:

- The resident individual is an employee or a director of (i) an office in India or a branch of an overseas entity or (ii) a subsidiary in India of an overseas entity or (iii) of an Indian entity in which the overseas entity has direct or indirect equity holding;
- The issue of ESOP or employee benefits scheme are offered by the issuing overseas entity globally on a uniform basis.

Further, 'indirect equity holding' has been defined to mean indirect foreign equity holding through a special purpose vehicle or step-down subsidiary. Accordingly, to fulfil the criteria in point a(iii) above, the overseas entity is required to have either (i) direct equity holding in the Indian entity, or (ii) an indirect equity holding through an SPV or subsidiary which is controlled by such overseas entity.

The OI Rules have clarified that while a resident individual is permitted to acquire foreign shares or interest under ESOP or employee benefits scheme or sweat equity shares without limit, the value of such shares/ interest will count towards such individual's LRS limit of USD 250,000. In other words, if an individual has to send USD 100,000 as grant price on exercise of the ESOPs in a financial year, they will only be permitted to remit USD 150,000 outside India under LRS.

II. Issue of ESOPs by Indian Companies to Employees Abroad

India's exchange control regulations allow an Indian company to issue shares as ESOPs and or sweat equity shares to its employees/ directors or employees/ directors of its holding company or joint venture or wholly owned overseas subsidiary/ subsidiaries who are resident outside India provided that:

- 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;
- The ESOPs or sweat equity shares are in compliance with the sectoral cap applicable to the said company;

1 Sweat equity shares have been defined under the Foreign Exchange Management (Overseas Investment) Rules, 2022 to mean such equity shares as are issued by an overseas entity to its directors or employees at a discount or for consideration other than cash, for providing their know-how or making available rights like intellectual property rights or value additions, by whatever name called;

- Issue of ESOPs or sweat equity shares in a company where investment by a person resident outside India is under the approval route requires prior Government approval;
- Issue of ESOPs or sweat equity shares to a citizen of Bangladesh/ Pakistan requires prior Government approval.

An individual who is a person resident outside India exercising an option which was issued when he or she was a person resident in India shall hold the capital instruments so acquired on exercising the option on a non-repatriation basis.

The Indian company is required to furnish a return within 30 days of issue of ESOPs or sweat equity shares in a prescribed format to the Regional Office concerned of the RBI under whose jurisdiction the registered office of the company operates.[2]

2 Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 RBI/FED/2017-18/60 FED Master Direction No. 11/2017-18 as amended upto January 4th, 2018.

Tax Implications for ESOPs / Sweat Equity Shares

The tax regime for ESOPs in India has evolved overtime. Initially, ESOPs were considered perquisites and taxed in the hands of the employee, unless the employer met certain guidelines prescribed by the Ministry of Finance and submitted a copy of the plan to the Chief Commissioner of Income-tax. In 2007, ESOPs were included in the Fringe Benefit Tax ("**FBT**") regime whereby the companies were made liable to pay FBT upon the exercise of stock options. However, the companies were entitled to recover the amount of tax from the employee. In 2009, the FBT regime was abolished by the government and the perquisite taxation for ESOPs re-introduced. Under the extant rules for taxation of ESOPs, an ESOP is taxed at two stages. First, at time of exercise of the options and second, at the time of sale of the securities acquired pursuant to exercise of the option. No tax is levied at the time of grant of options or vesting of options.

I. Taxation at Time of Allotment

Section 17(2)(vi) of the ITA provides that value of any specified security allotted or transferred, directly or indirectly, by the employer, or former employer, to the employee, free of cost or at discount is considered as a 'perquisite' in hands of the employee. Accordingly, at the time of exercise, the difference between the fair market value ("**FMV**") of the shares as on the date of the exercise and the exercise price payable by the employee is characterized as 'perquisites' and taxed in the hands of the employees. Since perquisites form a component of the 'salary income' pursuant to the provisions of Section 17 of the ITA, the employer is obligated to deduct taxes on such income in accordance with the provisions of section 192 of the ITA and pay the same to the government.

The fact that upon exercise, the employee only receives shares of the start-up and no cash results in a significant tax burden on the employee. A similar burden is also faced by the start-up, which is required to withhold tax on the benefit accruing to its employee. Finance Act, 2020 amended section 192 of the ITA to ease both the employee's and eligible start-up's[1] tax burden by allowing them to defer payment / deduction (as the case may be) of tax on the ESOP to within 14 days:

a. After the expiry of 4 years from the end of assessment year in which shares are allotted; or

b. From the date on which the employee ceases to be employed by the eligible start-up; or

c. From the date of sale of shares allotted under ESOP by the employee

Whichever is earliest. However, the amount of tax payable / deductible will be calculated as per the rates in force at the time the shares were first allotted or transferred to the employee.

1 The benefit of deferment of withholding tax on ESOP is available to 'eligible start-up', the eligibility criteria for which is (i) The start-up should be incorporated as a company or LLP on or after 1st April 2016 but before 31st March 2023; (ii)The entity should be engaged in innovation, development or improvement of products or services or processes (iii) The turnover of the entity for any of the financial years since incorporation should not exceed 100 crores; (iv) The start-up must hold a certificate from the Inter-Ministerial Board (IMB) of an eligible business.

The FMV of the shares issued upon exercise of the options is valued in accordance with the rules notified by the tax department for valuation of perquisites ("**Perquisite Valuation Rules**").[2] As per the Perquisite Valuation Rules, the FMV for equity shares or securities allotted or transferred on or after April 1, 2009 to an employee is to be calculated as under:

- In case the equity shares in a company listed on a recognised stock exchange on the date of exercise of option, the FMV is the average of the opening price and closing price of the equity shares on the date of exercise on that recognised stock exchange.
- In case the equity shares are listed on more than one recognised stock exchange on the date of exercise of option, the FMV is the average of opening price and closing price of the equity shares on the date of exercise on the recognised stock exchange which records the highest volume of trading in the equity share.
- In case the equity shares in the company are listed on a recognized stock exchange in India, on the date of exercise of the options however there is no trading in equity shares on such date, FMV is:
  - the closing price of the equity shares on any recognised stock exchange on a date closest to the date of exercise of option and immediately preceding such date; or
  - the closing price of the equity shares on a recognised stock exchange, which records the highest volume of trading in such shares, if the closing price, as on the date closest to the date of exercise of option and immediately preceding such date, is recorded on more than one recognised stock exchange.
- In case the equity shares in the company are not listed on a recognized stock exchange in India on the date of exercise of the options, the FMV is such value on the specified date as determined by a category I merchant banker registered with the SEBI.
- In case of any other security, FMV on the date of exercise of the option is such value as determined by SEBI registered Category I merchant banker on specified date.

This valuation methodology is applicable also in case the shares are listed on overseas stock exchanges. The specified date in this context shall be the date of exercise of the options, or any day prior to the date of the exercise, not being more than 180 days earlier than the date of the exercise.

The Perquisite Valuation Rules do not define the 'date of exercise that should be considered for the purposes of computation of FMV. The date of exercise could therefore be construed to mean the date the employee submits the exercise form or the date the company receives payment and allots or transfers shares to the employee. No clarification has been provided pertaining to this ambiguity and pending such clarification, companies in India are assuming that since tax is payable on the date of allotment, the date of exercise would be the same date.

II. Taxation at Time of Subsequent Sale by Employee

The second tax incidence occurs at the time of sale of allotted shares by the employee. In this case, the employee is subjected to capital gains tax which is calculated as the difference between the sale price and the FMV of the shares at the date of exercise by the employee. In such a case, the period of holding is computed from the date of allotment of such shares and the FMV computed for purposes of section 17(2)(vi) is considered as the cost of acquisition of such shares.[3]

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2 Rule 3 of the Income-tax Rules, 1962.

3 Section 49(2AA) of the ITA

In case the shares held are listed on a stock exchange, long term capital gains ("**LTCG**") arises when the shares are held for more than 12 months from date of exercise. If shares are sold within 12 months, they are considered short term capital gains ("**STCG**"). As per section 112A of ITA, LTCG, in excess of INR 1 lakh, arising from sale of listed equity shares where securities transaction tax ("**STT**") is paid both at the time of acquisition and transfer will be subject to tax at the rate of 10% without availing the indexation benefit. A notification[4] issued by the central government inter alia provides that ESOPs shall be covered within the ambit of section 112A of ITA even though at the time of acquisition STT was not paid. STCG on sale of listed equity shares is taxable at the rate of 15%.[5]

In case of shares of an unlisted company, LTCG arises if shares are held for a period of 24 months or more. If shares are held for less than 24 months, STCG arises. STCG is taxed at the applicable income tax slab rate whereas LTCG is taxed at 20% after indexation of cost.

4 Notification No. 60/2018/F. No. 370142/9/2017-TPL dated 1 October 2018.

5 Section 111A of the Act.

Taxation of SARs

In case of equity settled SARs, the employee becomes eligible to acquire proportionate number of shares of the company on the date of redemption. In case of cash settled SARs/ PSOs, the employee becomes eligible to receive proportionate cash compensation on the date of redemption. The amount received on the date of redemption is computed as the difference between the FMV of shares at the date of grant of SARs and the FMV of shares on the date of redemption.

As per the ITA, equity settled SARs are treated at par with ESOPs. However, a cash settled SAR/ PSO is a revenue receipt in the hands of the employee and is taxed as income under the head 'Salaries'. Accordingly, tax is deduced at source by the employer and the cash compensation made by the employer is an allowable expenditure under Section 37 of the ITA.

The compensation mechanism and tax treatment of SARs has been distinguished from that of ESOPs in the landmark judgment in the case of *Sumit Bhattacharya v. Asstt. Commissioner of Income Tax*[1] in which it was observed that the redemption value of a SAR is primarily a deferred wage or bonus payment, in cash or otherwise measurable with reference to the appreciation of market price of the company's shares. While redemption of SARs results in a receipt of monetary reward or deferred bonus to the employee contingent on the company's financial performance; exercise of ESOP results in acquisition of a capital asset at a concessional price by the employee. Therefore, the legal and tax position regarding the amount received on redemption of SARs and the value derived from exercising ESOPs cannot be treated on a *pari passu basis*.

Tax liability is triggered at the date of redemption of the SARs and the amount received is treated as consideration for services rendered by the employee and is hence of revenue nature and taxed under the head 'Income from Salaries'.

1 Sumit Bhattacharya v. Asstt. Commissioner of Income Tax (03.01.2008 – ITAT Mumbai) 2008 (1) TMI 655.

Issues in Cross Border ESOPs

I. Presence of Employer-Employee Relationship

Often foreign companies grant ESOP to employees of their subsidiaries. In such cases, courts have held that the parent company had given the ESOP to employees of Indian subsidiaries so as to motivate the employees, therefore, indirectly benefitting from services of employees.[1] Courts have held that employer-employee relationship is not necessary for an income to be taxed under the head 'Salaries'. It is enough if the sum earned is a reward for services rendered by the employee.[2] In most such cases, the parent company may be recovering the benefit so provided by way of cross charge from the subsidiary.

II. When do Benefits Accrue to Employees — During the Vesting Period or at Time of Exercise of Shares by Employees?

Foreign employees of multinational companies who come to work in India on deputation or secondment, and exercise their ESOPs while working in India, are typically taxed as per the ITA on a proportionate basis. The relevant bilateral tax treaties between India and the foreign jurisdictions also needs to be examined to assess the exact tax implications arising in such cases.

The Delhi Income Tax Appellate Tribunal ("**ITAT**") in the case of *Robert Arthur Keltz*,[3] held that in situations where the expatriate was employed in India only for a certain fraction of the vesting period under a global ESOP, only such fraction of the ESOP perquisite is taxable in India at the time of exercise of the stock option, in case the employee is categorized as a Resident but Not Ordinarily Resident ("**RNOR**").

In that case, an employee ("**Employee R**") of United Technologies International Operation ("**UTIO**"), a company based in the USA, was granted ESOP for 34,000 shares in January 2004 with a vesting period of 3 years from the date of grant. He was sent on secondment to UTIO's Indian liaison office ("**UTIO ILO**") in April 2006. He exercised the options in February 2007 while on his assignment in India.

Employee R filed his income tax return for the financial year 2007-2008 as an RNOR and offered to tax such fraction of the ESOP perquisite[4] equal to the fraction of the vesting period for which he excised employment in India. However, the Income-tax Assessing Officer ("**AO**") ruled that Employee R's taxable income would include the total ESOP perquisite. In appeal, the Commissioner of Income Tax (Appeals) ("**CIT(A)**") reversed the AO's order.

1 Soundarrajan Parthasarathy and Ors. v. The Deputy Commissioner of Income Tax (05.05.2016 – ITAT Chennai) [2016]159 ITD 21(Chennai).

2 Sumit Bhattacharya v. ACIT [2008] 112 ITD 1 (Mum)(SB); ACIT v. Chittaranjan A. Dasannacharya [2014] 64 SOT 226 (Bangalore-Trib.).

3 Assistant Commissioner of Income Tax v. Robert Arthur Keltz, dated May 24, 2013 (Robert was represented by UTIO ILO).

4 Under section 17(2)(vi) of the ITA, in case of ESOPs, the difference between the market price on the date on which the option is exercised and the price payable on exercising the option is treated as a perquisite.

In further appeal, the ITAT noted that Employee R's operation from outside India during the remainder of the vesting period of the ESOP (which was prior to Employee R's deputation to India) did not involve the performance of any service connected with any India-specific job or activity. Hence, the ITAT held that only a proportionate stock option benefit, which is relatable to the service rendered in India is taxable in India. The Delhi ITAT followed its earlier decisions[5] in doing so.

The principle of apportionment applied in this case has also been upheld in several other domestic[6] as well as foreign cases.[7] It is also in conformity with the 2017 OECD Model Tax Convention on Income and Capital[8] which states that where a stock option is derived from employment exercised in more than one country, the portion of the benefit derived from employment in each individual country should be determined based on the number of days during which employment has been exercised in a country to the total number of days of employment from which stock option income is derived.

However, the principle of apportionment has been disregarded in the more recent case of *Soundarrajan Parthasarathy.*[9] In that case, the Court examined the issue of taxation of SARs of globally mobile employees and held that merely because the employees were non-residents and rendered services outside India during the vesting period, they could not avoid tax liability in India because they were residents in India at the time of exercise of the SARs. Therefore, what is important is the residential status of the employee at the time of exercise of the right and the residential status of the employee during the vesting period is irrelevant while determining tax liability in such cases.[10]

Both employers and employees must take cognizance of the aforementioned tax related issues at the time of offering and accepting any form of ESOP. This is especially critical for multinational companies who send foreign employees to India on secondment schemes as they may be subjected to greater tax liabilities than Indian employers due to the impact of tax equalization.

In the absence of any specific binding High Court or Supreme Court decision on the issue, the question of whether exercise of ESOPs and SARs by globally mobile employees should be taxed proportionately or not remains a grey area as tax tribunals of various states have adopted divergent interpretations on the issue.

III. Issuance of Esops by Indian Holding Company to Employees of Overseas Company

The question whether the benefits under ESOPs of an Indian company to an employee of overseas company should be taxable in India even when the employee has not rendered any services in India both during the vesting period and during the exercise period is also litigated.

As per provisions of section 5(2)(a) of ITA, the total income of a non-resident includes all income, from whatever source derived, which is received or deemed to be received in India or accrues or arises or is deemed to accrue or arise in India. There may be a situation wherein during the vesting period, the non-resident employee has not performed any services in India but has continued to render services to the employer in his own country.

5 DCIT v. M/s Eric Morquxer and Ghorayeb Emile, 2008-TII-11-ITAT-DEL-INTL; ACIT v. Ellin 'D' Rozario, dated 5th December, 2008.

6 DCIT v. M/s Eric Morquxer and Ghorayeb Emile, 2008-TII-11-ITAT-DEL-INTL; ACIT v. Ellin 'D' Rozario, (ITA 2918/D/2005); Anil Bhansali v. Income Tax Officer (21.01.2015 – ITAT Hyderabad).

7 Finland-Case 4.8.2004/1773, 4 August 2004 and Switzerland-Case 104/2003, 10 October 2003).

8 Articles of the OECD Model Tax Convention on Income and Capital, 2017.

9 Soundarrajan Parthasarathy and Ors. v. The Deputy Commissioner of Income Tax (05.05.2016 – ITAT Chennai) [2016]159ITD21(Chennai).

10 Markand Gadre v. ACIT [ITA Nos. 1278 (Hyd) of 2003 and 940 (Hyd) of 2005].

In such a case, it may be possible to argue that income has not accrued in India nor would be deemed to accrue to him in India.

In the case of *Unnikrishnan V S vs. Income Tax Officer*,[11] the assessee, an employee of HDFC Bank Limited, was working in Dubai on deputation since 1st October 2007. HDFC granted the options to the assessee in June 2007 and the assessee exercised the options while working in Dubai. The assessee contended that the ESOP benefits are received by the assessee on account of services rendered in connection to employment with Dubai representative office of HDFC in UAE and that the ESOP perquisites do not accrue or arise in India and cannot be taxed under the provisions of the ITA.

The Tribunal observed that the ESOP benefit relate back to the point of time, and even periods prior thereto, when the benefit is granted. Therefore, it cannot be viewed as accruing or arising at the point of time when the ESOP benefits are exercised. It was held that the income that is being taxed now is a fruit of services rendered much earlier and the benefit, which has now become a taxable income, accrued to the assessee in 2007. Section 17(2)(vi) only decides the timing of the income arising from ESOP, it does not negate the fact that the benefit sought to be taxed has arisen much earlier.

Therefore, in order to determine taxation of income from ESOPs it is important to determine the place where 'services have been rendered' or 'employment exercised' by the employee.

11 ITA Nos. 1200 and 1201/Mum/2018.

Deductibility of ESOP Expenditure

Section 37(1) of the ITA provides as under:

> *"Any expenditure not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee, laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession"*

On basis of perusal of section 37, the following conditions should be satisfied to claim a deduction:

- Expenditure should not be of the nature described in sections 30 to 36 of the ITA;[1]
- Expenditure should not be in the nature of capital expenditure;
- Expenditure should not be in the nature of personal expenses of the assessee;
- Expenditure should be laid out or expended wholly and exclusively for the purposes of the business or profession

The issue on deductibility of ESOP expense has been settled by the decision of the ITAT (Special Bench) in case of *Biocon Ltd. v DCIT, [2013] 35 taxmann.com 335 (Bangalore — Trib.) (SB)*. The following principles have been reiterated by Indian High Courts and Tribunals[2] in numerous cases:

- ESOP expense is not in the nature of capital expenditure as it is only a payment of salary in kind rather than in money (cash/bank);
- The primary objective for issuance of shares to employees at a discounted price is not to raise share capital, but to earn profit by securing the consistent and concentrated efforts of its dedicated employees during the vesting period. Such discount is a substitute to giving direct incentive in cash for availing the services of the employees;
- The grant of ESOP is simply one of the modes of compensating the employees for their services and is a part of their remuneration. Such discount cannot be described as either a short capital receipt or a capital expenditure. It is nothing but the employees cost incurred by the company by undertaking to issue shares at discounted premium, the company does not pay anything to its employees, but incurs obligation of issuing shares at a discounted price on a future date in lieu of their services, which is nothing but an expenditure under section 37(1);
- Once ESOP expense is held as a consideration for employment, the natural corollary which follows is that such discount i) is an expenditure; ii) such expenditure is on account of an ascertained (not contingent) liability; and iii) it cannot be treated as a short capital receipt. Therefore, discount on shares under the ESOP is an allowable deduction.

1 Section 30 to section 36 of the ITA should not be applicable in this case.

2 [2021] 131 taxmann.com 187 (Kar.) Commissioner of Income-tax (LTU) v. Biocon Ltd.; [2019] 104 taxmann.com 26 (Delhi) Pr. CIT v. Lemon Tree Hotels (P.) Ltd.; M/s. Northern Operating Services Pvt. Ltd. vs JCIT IT(TP)A No.759/Bang/2017; [2017] 80 taxmann.com 325 (Chennai-Trib.) Caterpillar India (P.) Ltd. v. DCIT, Chennai; [2020] 117 taxmann.com 212 (Delhi-Trib.) New Delhi Television Ltd. v. ACIT Circle 13(1); [2022] 134 taxmann.com 351 (Delhi-Trib.) ACIT v. People Strong HR Services (P.) Ltd.

While the above cases pertain to a cost reimbursement by the Indian company to the foreign company, the principle of allowing of deduction with respect to ESOP expense should be applicable in all cases.

The ITAT(SB) in the Biocon case while holding that ESOP expense is an ascertained liability despite the fact that the exact amount of expense may be determinable on a future date held as under:

> *"9.3.5 When we consider the facts of the present case in the backdrop of the ratio laid down by the Hon'ble Supreme Court in Bharat Earth Movers (supra) and Rotork Controls India (P.) Ltd. (supra), it becomes vivid that the mandate of these cases is applicable with full force to the deductibility of the discount on incurring of liability on the rendition of service by the employees. The factum of the employees becoming entitled to exercise options at the end of the vesting period and it is only then that the actual amount of discount would be determined, is akin to the quantification of the precise liability taking place at a future date, thereby not disturbing the otherwise liability which stood incurred at the end of the each year on availing the services.*
>
> *In any case, if some of the options remain unvested or are not exercised, the discount hitherto claimed as deduction is required to be reversed and offered for taxation in such later year. We, therefore, hold that the discount in relation to options vesting during the year cannot be held as a contingent liability."*

At this juncture, it is important to note that the ITAT has held that employer is allowed to take deduction of the proportionate amount of ESOP expense over the vesting period. Importantly, the ITAT has also noted that in case where the options remain unvested or are not exercised, the expense claimed as deduction is required to be reversed and offered to tax in that year.

Interestingly, the ITAT (Special Bench) also delves into the issue of whether any subsequent adjustment is warranted at the time of exercise of options, to the deductions earlier allowed for such expense. In this regard, the ITAT has held as under:

> *"11.1.2 We have noticed above that the company incurs a definite liability during the vesting period, but its proper quantification is not possible at that stage as the actual amount of employees cost to the company, can be finally determined at the time of the exercise of option or when the options remain unvested or lapse at the end of the exercise period. It is at this later stage that the provisional amount of discount on ESOP, initially quantified on the basis of market price at the time of grant of options, needs to be suitably adjusted with the actual amount of discount.*
>
> *11.1.3 As regards the adjustment of discount when the options remain unvested or lapse at the end of the exercise period, it is but natural that there is no employee cost to that extent and hence there can be no deduction of discount qua such part of unvested or lapsing options. But, as the amount was claimed as deduction by the company during the period starting with the date of grant till the happening of this event, such discount needs to be reversed and taken as income.*

> *It is this market price at the time of the grant of options which is considered for working out the amount of discount during the vesting period. But, since actual amount of employees cost can be precisely determined only at the time of the exercise of option by the employees, the provisional amount of discount availed as deduction during the vesting period needs to be adjusted in the light of the actual discount on the basis of the market price of the shares at the time of exercise of options. It can be done by making suitable northwards or southwards adjustment at the time of exercise of option."*

It is important to note that the ITAT has in effect permitted upward or downward deduction of ESOP expense which technically pertains to earlier years in the year of exercise or lapse of option by the employees. This decision has been upheld by the Karnataka High Court.[3]

3 [2021] 131 taxmann.com 187 (Kar.).

TCS of Remittance for ESOPs

As mentioned above, the OI Rules permits resident individuals to remit money outside India to acquire shares under ESOP or employee benefit scheme without any limit. It is important to note that remittances under the LRS will be subject to tax collection at source (**"TCS"**) in accordance with the with section 206C(1G).

The ITA imposes an obligation on the Authorized Dealer Bank (**"AD Bank"**) to collect TCS at the rate of 5% provided the remittance exceeds INR 7,00,000 in a financial year. The rate for TCS has been increased to 20% for remittances from October 1, 2023. Credit of the TCS undertaken by the AD Bank will be available to employee at time of filing of income-tax returns.

International Perspective on ESOPs

United States of America

ESOPs are popularly granted in the US as a part of an employee's overall compensation package.[1] Incentive stock options ("ISOs") and Non-qualified stock options ("NSOs") are the popular forms of ESOPs that are issued in the US.

An ISO is a type of statutory stock option where an employer gives employees an opportunity to purchase stock at a fixed price during a specified time. The term / vesting schedule of these options are statutorily fixed, i.e., such period cannot exceed 10 years and the exercise price must be equal to or more than the value of the stock at the time of grant, and options for no more than $100,000 worth of stock (determined at time of grant) may become exercisable in any year.[2]

The NSO is much like an ISO, that is, an offer by an entity (employer or other entity) to sell its stock to an individual (e.g. employees, directors, consultants, contractors, vendors, and even other third parties) for a specified price at any time during a specified period. In exercising stock options, an employee incurs a tax liability equal to the difference between the market and exercise price that is reported as wages.[3] Unlike ISOs, NSOs may be granted to any service provider, e.g. employees, directors, consultants, vendors and even other third parties and may or may not include a vesting schedule. Their expiration is more flexible without a fixed period. NSO don't qualify for special tax treatment. This means that an individual pays tax when they exercise and when they sell the shares. As NSOs are non-qualified, they're unrestricted.

United Kingdom

ESOPs are popular in the UK in both private and public companies. A company in which employees hold 25% or more stake is commonly known as 'employee-owned'. Company Share Option Plan (CSOP); Enterprise Management Initiatives (EMI); "Save As You Earn" Share Schemes (SAYE) and Share Incentive Plan (SIP) are some of the common types of ESOP schemes used in the UK. These schemes are all tax advantaged and typically free from income tax and National Insurance contributions. Options issued other than these schemes are known as "unapproved" schemes and are not exempted from income tax and National Insurance contributions.

i. In CSOP, employees and directors who hold less than 30% of the company can be granted stock options at a pre-determined price to be exercised at a future date.

ii. In SAYE schemes, eligible employees and directors must enter a savings contract for a period of 3 or 5 years called as certified SAYE savings arrangement to buy stocks at the end of a fixed term. This savings arrangement typically also earn interest for the employees. If the holders do not wish to purchase stocks, they may withdraw their savings along with any interest accrued and use them for other purposes.

1 https://www.bea.gov/index.php/system/files/papers/P2000-6.pdf.

2 Supra.

3 Supra.

iii. EMI is a type of ESOP scheme used by small companies whose gross assets do not exceed £30 million; are not controlled by another company; and operate in certain notified sectors. There is no limit on the number of participants to this type of scheme provided that the maximum value of the options does not exceed £3 million in aggregate.

iv. SIP is a tax-advantaged ESOP under which shares are held by a special employee benefit trust on behalf of the employee. Under SIP, companies may structure four different types of share award depending on the intended beneficiaries: free shares, partnership shares; matching shares and dividend shares.[4]

Singapore

Similar to India, companies in Singapore are required to obtain approval of Shareholders in a general meeting before adopting ESOPs and fulfill other applicable compliances such as adhering to restrictions on quantum of shares issued and eligibility conditions. Under an ESOP, the options have a minimum vesting period of one-year and a maximum of five years to expiration. In addition to traditional ESOP, other forms of ESOPs used in Singapore are:

i. **ESAP**: ESAP allows companies to award employees actual shares for free, instead of stock options.

ii. **Phantom Share Option Plan** (**"PSOP"**): PSOP which allows employees gets the cash bonus relating to the increase in the stock value of the company over a specified period.

Germany

ESOPs are not very popular in German companies because unlike many other jurisdictions, ESOPs are not tax-advantaged in Germany. However, many foreign companies doing business in Germany do issue ESOPs. In Germany, ESOPs are granted on a discretionary basis to individual employees and not on a uniform basis. Further, members of the Board of Directors are also eligible to receive ESOPs. Apart from traditional ESOPs, SARs and PSOPs, the following types of ESOPs are commonly issued in Germany:

i. **Virtual Share Options Plans** (**"VSOP"**): VSOPs are conceptually similar to PSOPs and employees do not receive actual shares, but instead receive the cash equivalent of the value of appreciation in the shares in the market on the exercise date.

ii. **EPC/ESC**: Using these certificates, companies incentivize employees by issuing bonds which provide profit-based interest. These certificates are especially suitable for unlisted companies.

4 For further information on ESOPs in UK, please refer to: https://uk.practicallaw.thomsonreuters.com/1-503-1411?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1.

France

ESOPs and employee profit sharing plans are fairly common in French companies and MNCs operating in France. It is mandatory for certain companies employing 50 or more employees to have an employee profit sharing plan. Some common types of ESOPs used in France are as follows:

i. **Share Option Plans** (“**SOP**”): This option is extended by employers towards their employees as options to purchase or to subscribe shares of the company.

ii. **BSPCE**: These are warrants giving the holder the right to subscribe to newly issued shares at a specific future date for a fixed price.

iii. **PEE**: PEE is a form of collective voluntary savings scheme that allows employees to participate in a portfolio of securities (including sometimes shares of the employer group companies), and that is eligible for a specific tax and social security regime.

iv. **FSA**: FSA includes plans for the grant of shares for no consideration to be paid by the employee, also called conditional shares awards, which can be presence or performance-based, are available. French and foreign companies can grant the awards provided the below conditions are satisfied.

In France, a legislation was passed on in 2015 (Loi Macron), which created an additional attractive legal, tax and social regime for qualified share awards.[5]

Japan

In Japan, following options are usually preferred by companies:

v. **ESPP**: Under the ESPP, eligible employees are offered participation in the ESPP implemented by foreign parent companies. Once enrolled, the employees contribute to the ESPP by payroll deductions of a certain amount determined in advance of the enrolment for the prescribed purchase period (commonly six months). Usually, on completion of the purchase period, the employees can purchase shares of the foreign parent company using the deducted and accumulated amount at a certain discount (for example, 15%) from the lower of either:

- the market price at the commencement of the purchase period, or
- the market price at the end of the purchase period.

Generally, the discounted portion is covered by the foreign parent company (or the Japanese local entity, as the case may be).

vi. **RSU**: RSU award gives the right to receive shares of foreign parent companies on satisfaction of the applicable vesting requirements, such as continued employment for certain years at the Japanese subsidiary or affiliate. When an RSU award vests, the shares of the foreign parent company are automatically issued to the employee without any monetary payment by the employee, unlike a share option where the employees are required to pay an exercise price to acquire the shares or the ESPP where the prior payroll deduction is mandatory. Until vesting, the employee does not have shareholder voting rights and does not receive any dividends. At vesting, the shares are issued without further restrictions and the employee is free to sell the shares at any time.

5 For further information on ESOPs in France, please visit: https://uk.practicallaw.thomsonreuters.com/7-503-0017?transitionType=Default&contextData=(sc.Default).

Conclusion

ESOPs have been widely recognised to encourage employee productivity by enhancing the level of employee participation and commitment. That said, there is still a lack of knowledge and awareness about stock options and a preference for immediate and upfront cash compensation among Indian employees. Although the Government has provided significant incentives to startups in the context of issuing ESOPs and sweat equity, recent reports indicate that several early-stage startups are struggling to implement their ESOPs effectively. There are still a few grey areas surrounding the regulation of ESOPs such as the ambiguity surrounding the regulation of PSOs and taxation. Further, some segments of the industry have raised concerns about excluding independent directors from the ambit of “employee” under the extant law.

Also, despite the existence of the ESOP Regulations, most Indian companies continue to prefer plain vanilla ESOPs over other types of sophisticated equity-linked incentive plans. That said, the ESOP market in India remains bullish and is witnessing greater participation across industries every year.

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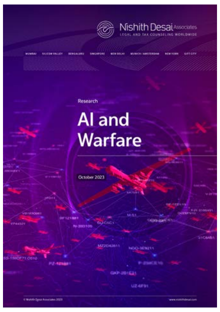

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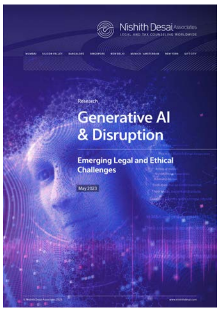

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