Employee stock Option plans

Pranshu goel

Partner
+91-9811311668
pranshu.goel@apcoindia.co.in

MEANING

MEANING

An Employee Stock Option Plan popularly known as ESOP, refers to an employee benefit plan which offers employees an ownership interest in the organization by issuing them shares of the company at a later date. These are options given to an employee of the company, to get the shares of the company at a pre-defined price. It is a right given to the employee, which an employee may exercise or not.

An organization grants ESOPs to its employees for buying a specified number of shares of the company at a defined price after the option period (a certain number of years). Before an employee could exercise his option, he needs to go through the pre-defined vesting period which implies that the employee has to work for the organization until a part or the entire stock options could be exercised.

WHY ESOPs
© Ashok Pranshu & Co.

WHY ESOPs

Start Ups often use ESOPs as a tool for attracting and retaining high-quality employees. Organizations usually distribute the stocks in a phased manner. For instance, a company might grant its employees the stocks at the close of the financial year, thereby offering its employees an incentive for remaining with the organization for receiving that grant.

Companies offering ESOPs have long-term objectives. Not only companies wish to retain employees for a long-term, but also intend making them the stakeholders of their company. Most of the IT companies have alarming attrition rates, and ESOPs could help them bring down such heavy attrition. Often such organizations are cash-strapped and are unable to offer handsome salaries. But by offering a stake in their organization, they make their compensation package competitive.

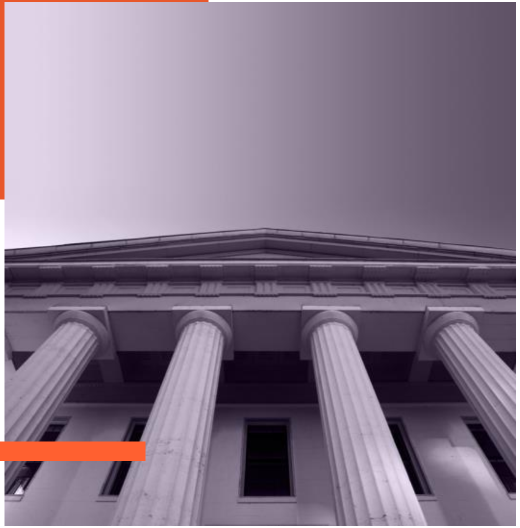
WHY ESOPs (Contd…)

On the other hand employee gets the benefit of acquiring the shares of the company at the nominal rate, and sell them (after a defined tenure set by his employer) and make a profit.

Stock options are provided by an organization as a motivation to its employees. As the employees would benefit when the company's share prices soar, it would be an incentive for the employee to put in his 100 percent. Although motivation, employee retention and awarding hard work are the key benefits which ESOP brings to the employers, there are several other noteworthy advantages too.

With the help of ESOP options, organizations could avoid the cash compensations as a reward, thus saving on immediate cash outflow. For organizations which are starting their business operations on a bigger scale or expanding their business, awarding their employees with ESOPs would work out to be the most feasible option than the cash rewards.

Who are using ESOPs



The scheme is mostly used by IT companies who were actually the first one to initiate this when the concept was introduced in India. But now, other sectors have also realized the potential that ESOPs hold.

As per a survey, while around 43% of the IT companies have given ESOPs to more than 90% of the employees, only 17% of the Non-IT companies have done so. More than 75% of the Non-IT companies offer ESOPs only to the senior and middle management employees.

Features of ESOPs

Features of ESOP

The conventional stock option plans give the employees a choice or option to a fixed proportion of shares in the company or their employer.

However, it must be understood that- **the employees are under no obligation to buy these fixed number of shares and they are free to reject the offer if they wish to.**

These offers vest over a period to an employee subject to fulfillment of certain conditions such as-

- continued employment for a specified period or
- there can be performance based plans wherein the employee has to meet certain level of performance as laid down by the Company.

TYPE OF PLANS

TYPE OF PLANS

When it comes to classifying the ESOPs, it can be divided under two categories, namely:

NON COMPENSATORY PLAN

It is the one under which the employees do not get compensation. The basic purpose of such plan is to either diversify ownership to include the employees or to raise additional capital for the Company. Under a non-compensatory plan the shares can be issued in future at the market price on the date of exercise/vesting.

COMPENSATORY PLAN

Under this category, the employees are compensated. In other words, services rendered by the employees are partially compensated for the issuance of shares at a discounted value. Companies use these kind of plans to motivate the employees. Compensatory plans are particularly useful for the fast growing knowledge-based companies that usually do not pay large salaries to the employees.

STOCK OPTION SCHEMES

EMPLOYEE STOCK OPTION SCHEME

An Employee Stock Option Scheme or ESOS is a right to buy shares at a pre-determined price. The option provided under this scheme confers a right but not an obligation on the employee. Stock options are subject to vesting that requires continued service over a specified period of time.

Upon vesting of options, employees can exercise the options to get shares by paying the pre-determined exercise price.

Employee Stock Purchase Plan (ESPP)

An ESPP provides the employees an option to purchase company shares often at a discount on FMV (fair market value) at grant or on exercise.

The plan term determines the date and price at which the employee is entitled to purchase company stock.

Phantom Equity Plan (PEP)

Under PEP, the employees are allotted notional shares/units at a pre-determined price.

When the employee fulfills the vesting conditions, he is paid cash equivalent to the net gain i.e. appreciation in the price of underlying shares without any cash investment.

These plans generally result in cash outflow for the company.

Restricted Stock Award (RSA)

Under RSA, an employee receives an award of stock, subject to certain underlying conditions.

If the underlying conditions are not met, the shares are forfeited.

The employee is considered to be the owner of the shares from the date of award, along with an entitlement to receive dividends and the voting rights.

The forfeiture conditions may be based on continued service over a specified period of time. The employee may be required to pay for RSA at grant which may be at a discount or more. It is usually awarded the stock at no cost.

Restricted Stock Unit (RSU)

Under RSU, an employee is awarded an entitlement to receive stock at some specified date in the future, subject to certain conditions.

These conditions may relate to performance or tenure of employment. Until shares are actually delivered, the employee is not a shareholder and does not have voting rights or rights to receive dividends.

TAX ON ESOP

TAX ON ESOP

The Income Tax Act, 1961 has laid down the taxation for employees in respect of shares allotted to them under an ESOP.

The difference between the Fair Market Value ("FMV") of the shares on the date of exercise and the exercise / subscription price paid by the employee, if any, is taxable as perquisite under the head 'Income from salary' on the date of allotment of shares.

It can be illustrated as follows:
Perquisite value of ESOP (on date of allotment) = (FMV per share – Exercise price per share) x number of shares allotted.

Upon allotment of shares, the employer will have to compute the perquisite value of ESOP taxable in the hands of the employee and deduct tax on such ESOP. The perquisite value and the tax deducted thereon by the company would be reflected in Form 16 and Form 12BA of the employee. The value of perquisite would be an expense for the employer.

Relevant regulations & Guidance on ESOP

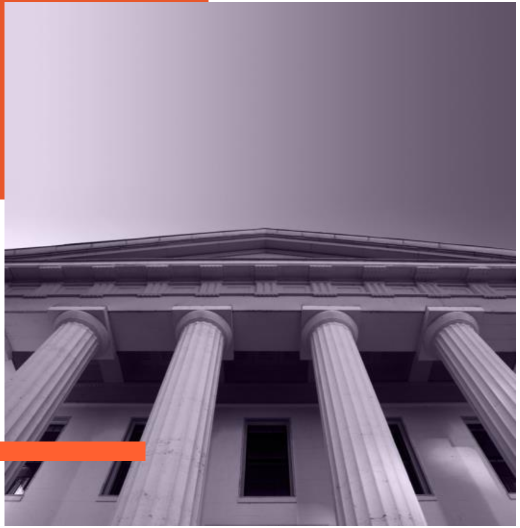
Relevant regulations & guidance

- Companies Act, 2013 and allied Rules;
- Income Tax Act, 1961
- Guidance Note on ESOP issued by Institute of Chartered Accountants of India.

Ashok Pranshu & Co.

Chartered Accountants

Leading to OUTCOMES…



About Ashok Pranshu & Co.

Ashok Pranshu & Co. established in the year 1993, is a group of experienced professionals, offering specialised auditing, accounting and legal services to the clients across the globe.

Our areas of service includes auditing, taxation (domestic and international), corporate laws, exchange control regulations, benami laws and money laundering.

Ashok Pranshu & Co.

Practice Area

Services We Render

- Auditing
- Direct and International Tax
- Transfer Pricing
- Goods and Services Tax
- Corporate and Exchange Control
- Private Client & Estate and Succession Planning
- Benami Prohibition and Anti Money Laundering

Meet Our Team

Pranshu Goel, LLB, FCA

Corporate Tax | International Tax
Auditing | Goods and Services Tax |
Anti-Money Laundering Laws | Benami
Laws

Pranshu Goel is a Member of Institute of Chartered Accountants of India since 2011 and graduated in law in the year 2014 from University of Delhi. He also holds a Certificate in Business Valuations from the Institute of Chartered Accountants of India. Pranshu has considerable experience in audits, advising and representing large corporate houses and high net worth individuals on a variety of tax matters including domestic, international as well as cross border.

A.K. Goel, FCA

Auditing | Individual Tax |
Corporate Tax | Goods and Services
Tax | Compliances

Ashok Kumar Goel is a Member of Institute of Chartered Accountants of India since 1977.
A.K. Goel has an extensive experience in handling statutory, internal and tax audits, income tax and goods and services tax advisory and compliances. He has advised and assisted various Corporate Houses and High Net-Worth Individuals in undertaking the compliances with various applicable laws and legislature.

Ashok Pranshu & Co.

Chartered Accountants

+91 9811 311 668 | www.apcoindia.co.in | info@apcoindia.co.in

A-29,
Swasthya Vihar,
New Delhi - 110092
+91 11 45511664

5A/3A, Ansari Road,
Darya Ganj,
New Delhi - 110002
+91 11 43507915