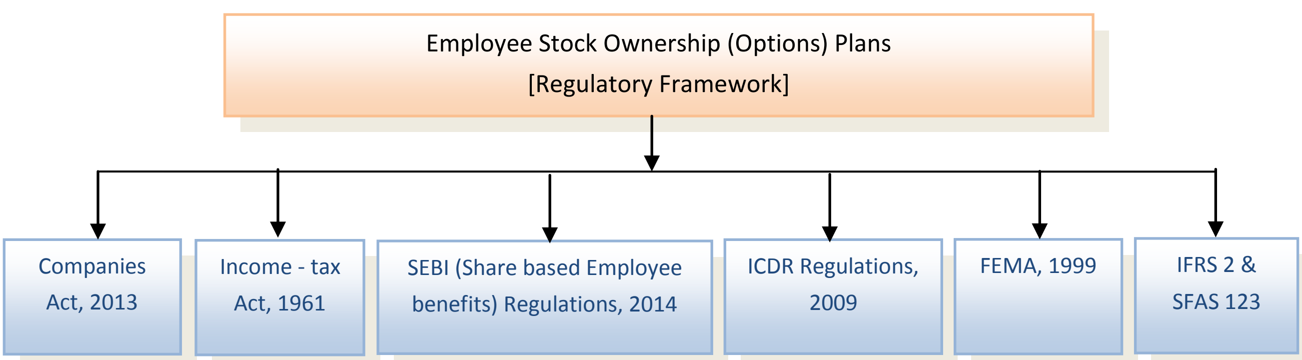
ESOP – INCOME TAX PERSPECTIVE

Prabhakar K S
Proprietor – Shree Tax Chambers

Introduction

1. The Employee Stock Ownership (Options) Scheme (Plans) has seven decades long history. During the 1950s, an unconventional form of ownership was developed by Louis O. Kelso, a political economist and corporate lawyer, who is chiefly remembered as the Father of the Employee Stock Ownership Concept. ESOP is a generic term representing a basket of incentives or investments meant for employees of a corporate entity. In strict Company Law parlance, it is an option given to the whole-time directors, officers or employees the benefit or right to subscribe to its securities at a future date but at a predetermined rate. As said, it is an innovative way to motivate, reward, remunerate and to retain the employees. In this way, a set of employees will be granted the ownership of the entity. Human resource is one of the most useful resources to run any enterprise. Since a few last decades, the companies are using unique but untraditional methods of remunerating its employees in the form of ESOS, ESPS and Sweat Equity, etc. In India, when it comes to regulatory aspect on ESOP, a number of Statutes are required to be studied and keep in one's mind such as the Company Law, the Income-tax Law, Securities Laws, Foreign Exchanges Regulations, and also to some extent of International Financial Reporting Standards and Statement of Financial Accounting Standards. Earlier, only ESOS and ESPS were under the ambit of SEBI or Stock market regulator. Now, same have been expanded to others such as SAR, Restricted Stock award. However, the current article is restricted to Indian Tax laws.



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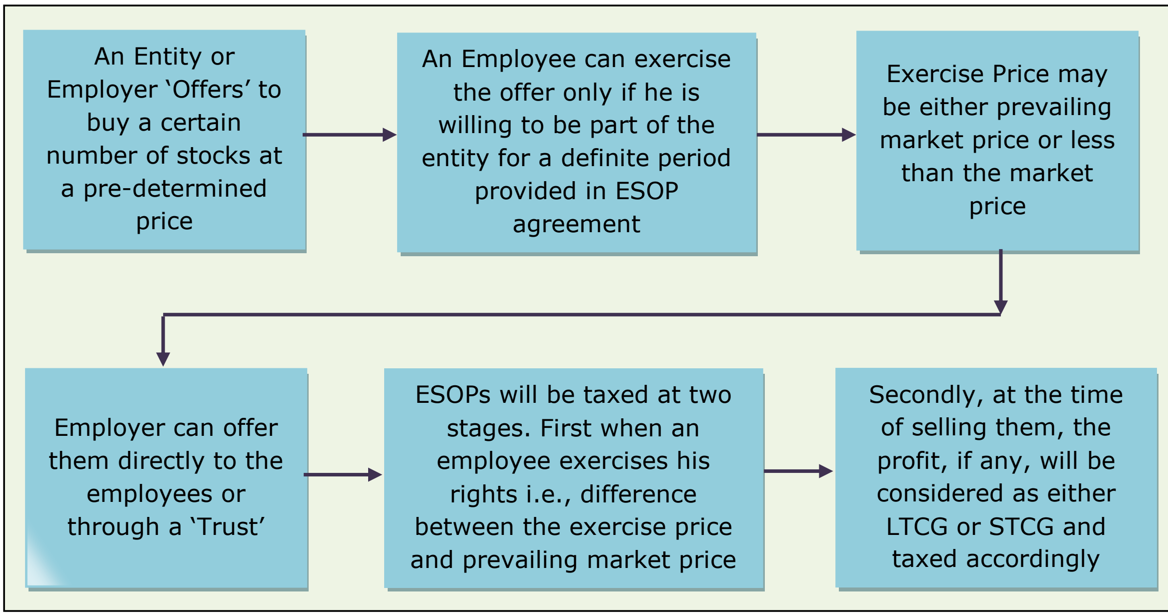
ESOP & its variance

2. There are certain variances of ESOPs, to name, Employee Stock Option Plan (ESOP), Employee Share Purchase Plan (ESPP) and Stock Appreciation Rights Plan (SAR), Sweat equity, Compensation Plans, Incentive Plans, Phantom ESOPs etc. However, In India the ESOP plan is prevalent due to regulatory restrictions. Under ESOP an entity grants an option to its 'eligible employees' to acquire its shares at a future date but at a predetermined price, whereas in ESPP a listed entity offers a right to acquire its shares instantly, unlike in ESOP at a future date for lower price compared to prevailing market prices with a lock-in-period. Under SAR, no such shares will be offered to its employee but he is given the appreciation in the value of shares between two specified dates as an incentive. SAR option is totally linked with the entity's performance as a whole. Restricted Stock award is an offer subject to certain conditions such as the employer has the right to cancel the entitlement if the conditions are not met. Sweat Equity shares are shares issued to its key directors and/or employees at a discount or for a consideration other than cash for providing know how or rights in the nature of intellectual property, etc.

Is it mandatory or optional? How ESOPs work?

3. No, it is not mandatory to accept or exercise the given option. It is left to the employee's discretion whether to exercise or let the option lapse in the case of prevailing prices of the shares is lower than the exercise price. In any case, the employee will be given a definite time period to opt for or forgone his rights. The date on which an employee exercises his option to buy them is known as 'exercise date'.



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Benefits of ESOPs to employer & Employee

4. The benefits of ESOPs to employer and employee are in many ways. To an employer, chiefly, ESOPs motivate its employees, helps in retaining the workforce and provide tax breaks. To an employee, it provides an incentive to remain in the company, upon retaining the talented workforce, the company will prosper and underlying shares will yield a good return. Overall, it will lead to improved efficiency, productivity & profits and same will be no doubt a win-win situation for all the concerned. It is a useful tool for startup companies or those who are at the growing stage to attract talented human resources. It can also be used for expansion, when an entity is going for acquisition, creating a new division, etc. The entity, which opts for ESOP financing provides attractive tax benefits, firstly, its contributions are tax deductible. Secondly, the dividends paid on ESOP stock passed on through to employees or used to repay the ESOP loan are also deductible.

Income Tax Provisions

5. Prior to amendments vide the Finance Act, 2009, the ESOPs were under the ambit of Fringe Benefit Tax (FBT).From then on, it has been made taxable in the hands of employees as 'Perquisites', subject to certain conditions. Where the capital gain arises from the transfer of specified security or sweat equity shares as referred to in clause (vi) of the sub-section (2) of section 17 of the Act, the cost of acquisition of such security or shares shall be the Fair Market Value (FMV) on the date on which the option is exercised by the employee. In case the ESOPs are granted by foreign entities to an Indian resident, the same are also taxable in India, are subject to double taxation avoidance agreement, if any.

Sub-section (2AA) of Section 49 deals with tax implications of ESOPs as under —

5.1 ***The issue of ESOPs and Tax implications:-***

5.1-1 *If ESOPs issued in any previous year but up to previous year 2008-09*

Under the head Salaries	Since ESOPs are perquisites, not taxable under this head.	
Under the head Capital Gains	Sale consideration	Regular
	Cost of acquisition	If shares are allotted before 1-4-2007- at Actual cost
		If shares are allotted on or after 1-4-2007 but before 1-

		4-2009 -at Value of shares on the date on which the option vests with the employee
Under the head Capital Gains *Transferred by the employee by way of gift or irrevocable Trust*	Sale consideration	Market value as on date of such transfer
	Cost of acquisition	If shares are allotted before 1-4-2007 -at Actual cost.
		If shares are allotted on or after 1-4-2007 but before 1-4-2009 - at Value of such shares on the date on which the option vests in the employee.

5.1-2 *If ESOPs are issued on or after 1-4-2009 or in assessment year 2009–10 onwards:-*

Under the head Salaries	As a Taxable Perquisite/Difference between FMV as on the date of exercise of his option and cost at which it is offered	
Under the head Capital Gains	Sale consideration	Regular
	Cost of acquisition	FMV
		MV as on date of such transfer
Under the head Capital Gains *Transferred by the employee by way of gift or irrevocable Trust*	Sale consideration	MV as on date of such transfer
	Cost of acquisition	FMV

As said, ESOP will be taxed in two stages. In first, when an employee exercises his option at the exercise price and thereafter, when the shares are sold. In the first stage, the difference between the exercise price and the value of the shares is treated as 'Perquisite' in the hands of the employee and the employer is required to deduct tax at source. The value of the shares allotted to the employee shall be the average of market price, *i.e.*, average of highest and lowest price, on the date when the option is exercised in case the shares are listed. In case of the unlisted shares, the FMV as per the Valuation Certificate obtained from the merchant banker. The said certificate should not be older than 180 days from the date of exercise of his option.

Again, when the shares are disposed off they will attract Capital Gains Tax. Same can be either long-term or short-term, depending on the holding period. However, the holding period is different for listed and unlisted shares. Listed shares shall become long-term if held for more than one year. Unlisted shares become long-term after three years. Further, by the Finance Act, 2018 the period of three years has been reduced to two years. In case shares are traded, the long-term capital gains will be taxed under section 112A at 10 per cent over Rs. 1 lakh of capital gain. Similarly, if it is short-term capital gains, then the same will be taxed at a flat rate of 15% under Section 111A of the Act.

In case of unlisted shares, the long-term capital gains shall be calculated after applying the indexation and any gains will be taxed at a flat rate of 20% plus applicable surcharge and education cess. An employee has an option to pay tax at 10% on capital gains without applying for indexation benefits.

6. Important Case Laws

6.1 *Infosys Technologies Ltd.* v. *Dy. CIT* [2003] 86 ITD 342 (Bang.) – The assessee it formulated an Employee Stock Option Plan. To execute it, a Trust was set-up and allotted a certain number of warrants. Each warrant entitled the holder, thereby to apply for and be allotted one equity share. The trust was to hold the warrant and transfer the same to the employees of the company under the terms and conditions of the ESOP. The right of exercise was made available at the defined time period subject to continuance in the service of the company for a definite period. The tax was deducted at source on the salaries paid to the employees under Section 192 of the Act. However, while estimating the salary, the assessee-company did not consider the ESOP. The assessee contended that no perquisite arose to an employee as a result of ESOP. Income Tax Appellate Tribunal, Bangalore Bench, held that no further liability could be imposed upon assessee.

6.2 *CIT* v. *A. K. Khosla* [2010] 191 Taxman 439/[2010] 327 ITR 406 (Mad.) - The assessee was a chartered electrical engineer employed as a chief executive officer in the Company. He retired from the said Company on 31-1-2001 and received certain amount as non - compete fee, for not taking employment in any competing organization. The Hon'ble Madras High Court observed that if the object of payment was unrelated to the employer-employee relationship, then the same would not fall within expression 'profit in lieu of salary' under Section 17(3)(*i*). Section 17(3)(*iii*) which deals with joining bonus or severance pay came into force only from the Assessment year 2002-03 onwards, since the provision was prospective in nature, 'profits in lieu of Salary' would not apply to the assessee.

6.3 *Biocon Ltd.* v. *Dy. CIT* [2013] 35 taxmann.com 335/[2014] 144 ITD 21 (Beng.-Trib.) (SB) - The assessee was engaged in the manufacture of Pharmaceutical Ingredients. In 2000, it formulated the ESOP through a Trust for giving effect to the ESOP 2000 and another ESOP 2004 which was launched subsequently but during one of the years. The appellantcompany granted certain options and claimed deduction of such amount as 'Employee Compensation Cost' u/s. 37 of the Act by representing as discount under the ESOP 2000. The Assessing Officer disallowed the said claim u/s. 143(3) of the Act on the ground that there was no specific provision entitling the assessee to a deduction. The Assessing Officer also held that the assessee was not entitled to weighted deduction u/s. 35(2AB) on the expenditure incurred on software research under Section 147 of the Act. The Special Bench held discount as an expenditure and allowed over the period of vesting to the company on Straight Line Method basis.

6.4 *Asstt. CIT* v. *Chittaranjan A. Dasannacharya* [2014] 45 taxmann.com 338/64 SOT 226 (Bang. Trib.) - The said Assessee was a software engineer. Initially, served a US company as an independent consultant and thereafter as an employee. After returning to India, he became an employee US Company's India Unit. The parent company granted a stock option to the assessee, which gave right to him to acquire certain shares of the parent company. On the same day of exercising his option, sold the said shares and earned income. The Bangalore Bench of Tribunal held that the assessee was to be regarded as an employee for purpose of impugned plan and benefits arising out of this arrangement would be treated as his income under head 'salaries'.

6.5 *Novo Nordisk India (P.) Ltd.* v. *Dy. CIT* [2014] 42 taxmann.com 168/63 SOT 242 (Bang. Trib.) - The assessee was a wholly owned subsidiary of Novo Nordisk A/S Denmark and primarily engaged in the marketing and distribution of healthcare products. In 2005,

Novo Nordisk AS, the parent company, issued employee sops under the name and style of 'NNAS Global Share Programme 2005'. Its employees were entitled to purchase said shares at a price less than the market price. As per the ESOP programme, the difference between FMV of shares of parent company on date of issue of shares and price at which those shares were issued by the assessee to its employees was reimbursed by the assessee to its parent company. The sum so reimbursed was claimed as an expenditure or employee cost in its books of account. The Assessing Officer rejected the claim of the assessee for deduction of the aforesaid expenditure on ground that it resulted in the capital building of the parent company. The Bangalore Bench of the Tribunal, by relying on *Sassoon J. David & Co. (P.) Ltd.* v. *CIT* [1979] 118 ITR 261/1 Taxman 485 (SC) and *Mysore Kirloskar Ltd.* v. *CIT* [1987] 166 ITR 836/30 Taxman 467 (Kar.) held that the expenditure in question was wholly and exclusively used for the purpose of the business of the assessee and motivated its workforce and the deduction under section 37(1) of the Act.

7. Important case laws for further study

- ✓ *Wipro Ltd.* v. *Dy. CIT* [2004] 2 SOT 611 (Bang.)
- ✓ *Alok Kumar* v. *Jt. CIT* [2007] 13 SOT 706 (Delhi)
- ✓ *Ravi Kumar Sinha* v. *Dy. CIT* [2007] 15 SOT 555 (Delhi)
- ✓ *Makarand Gadre* v. *Asstt. CIT* [2008] 21 SOT 454 (Hyd.)
- ✓ *CIT* v. *Infosys Technologies Ltd.* [2008] 166 Taxman 204/297 ITR 167 (SC)
- ✓ *Sumit Bhattacharya* v. *Asstt. CIT* [2008] 112 ITD 1 (Mum.) (SB)
- ✓ *Giridhar Krishna M.* v. *Asstt. CIT* [2009] 118 ITD 177 (Bang.)
- ✓ *Muthuswamy Ravikumar* v. *Asstt. CIT* [2009] 120 ITD 444 (Bang.)
- ✓ *Kanu Kumar Mukerji* v. *Asstt. CIT* [2008] 23 SOT 565 (Mum.)
- ✓ *Asstt. CIT* v. *Smt. Tripti Sharma* [2010] 1 ITR(Tri.) 471 (Mum)
- ✓ *Asstt. CIT* v. *Dr. Dhurjati Gupta* [2010] 127 TTJ 356 (Hyd.)
- ✓ *Asstt. CIT* v. *Pramod H. Lele* [2011] 13 taxmann.com 215/47 SOT 363 (Mum.)
- ✓ *Asstt. CIT* v. *Ambrish Kumar Jhamb* [2013] 32 taxmann.com 210/57 SOT 40 (URO) (Delhi - Trib.)
- ✓ *Asstt. CIT* v. *Robert Arthur Keltz* [2013] 35 taxmann.com 424/59 SOT 203 (Delhi - Trib.)
- ✓ *Mrs. Smita Anand,* In re [2014] 42 taxmann.com 366/223 Taxman 322/362ITR 38 (AAR – New Delhi)
- ✓ *CIT* v. *Bharat V. Patel* [2015] 54 taxmann.com 170/229 Taxman 236 (Guj.)

Concluding Remarks

8. It was reported in The Economic Times issue dated 20th September, 2018, that Walmart was obligated to buy set of ESOPs worth nearly $ 800 million from its Indian acquisition, Flipkart. The total worth of Flipkart's ESOP was about $ 1.5 Billion based on the per share purchase price. However, their current employees will be allowed to liquidate 50 per cent of their vested ESOPs. No doubt, the ESOP re-purchase programme is a reward to employees of any entity for their service contribution.