taxsutra All rights reserved

Employee Stock Options – A Tax and Accounting Conundrum

Mar 02, 2021

Ketan Dalal

Managing Partner, Katalyst Advisors LLP

Tanvi Shah

Katalyst Advisors LLP

Incentives to employees, commonly known as Employee Stock Options (“ESOPs”), have traditionally been an important form of compensating employees, particularly those involved in executive functions as well as those significantly contributing to growth of the business. For the last several years, considering the state of the capital market, the importance had somewhat reduced, but with the renewed uptick, the situation has again changed.

Introduction

Incentives to employees, commonly known as Employee Stock Options (“ESOPs”), have traditionally been an important form of compensating employees, particularly those involved in executive functions as well as those significantly contributing to growth of the business. For the last several years, considering the state of the capital market, the importance had somewhat reduced, but with the renewed uptick, the situation has again changed.

While the software industry led the wave (in 1990s) of using ESOPs and its variants for retaining talent, several other sectors followed suit over the last 3 decades. Share-based incentives have also gained popularity in recent years among start-ups looking to incentivise key personnel without impacting their cash flows.

Amongst other issues, the question whether ESOPs are an expense has been a long-standing controversy. One of the most telling insights has been provided by Warren Buffett, in a letter to Berkshire Hathaway shareholders, wherein he summed up the situation quite succinctly as follows:

- If options are not a form of compensation, what are they?
- If compensation is not an expense, what is it?
- And if expenses should not go into the calculation of earnings, where in the world should they go?

In the above context, one of the key tax issues regarding ESOPs is whether it is deductible for the employer, and in this context, a recent judgement of the Karnataka High Court (dated 11th November 2020) in the case of Biocon Ltd. (276 Taxman 1), has held in favour of the tax payer, and one would think justifiably so.

Downloaded by tanvi.shah@katalystadvisors.in at 02/03/21 03:37pm

taxsutra All rights reserved

In fact, there are also several other aspects relating to ESOPs – including the accounting treatment over the lifetime of the options (grant, vest, exercise) and taxability for the employees at various stages. Also, in relation to ESOPs and ESOS, there are SEBI Regulations titled "SEBI (Employee Share Based Payments) Regulations, 2014" which obviously need to be borne in mind. There are also references to ESOPs in the Companies Act, 2013 and in the listing regulations (SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015) which also need to be factored in. In addition, if a multi-national Indian conglomerate decides to issue ESOP to its employees or employees of its holding company or subsidiary company who are residents outside India, such issue is additionally regulated by Rule 8 of Foreign Exchange Management (Non-debt Instruments) Rules, 2019. The focus of this article is to deal with the interconnect between SEBI, Company Law, accounting and tax issues in relation to ESOPs.

Overview of share-based incentives

Stock-based incentives, as alluded to above, can be in different forms: ESOPs, stock appreciation rights (SARs), restricted stock units or stock purchase plans. Broadly, all share-based incentives intend to achieve the same objective – make the shares of the company available to the eligible personnel without any investment from the employee or at a deep discount, thus, giving a sense of ownership to the employees and aligning their performance with the growth of the company. However, each variation has a nuance, which has been briefly touched upon below:

ESOPs: Option is granted to employees to acquire certain number of shares in a company at a pre-determined price. Life cycle of ESOPs typically includes grant of options (i.e. employee receiving an option to acquire shares at a future date), vesting (when the right of exercise becomes valid and due with the employee) and exercise (when the employee actually exercises his right by paying the exercise price, if any). Vesting of the ESOPs can either be time-based or performance-linked or a combination of both.

Stock Purchase Plans: A plan/ scheme administered by the company, in which the participating employees can purchase shares at a discounted price using the funds accumulated by the company through payroll deductions.

SARs: A right given to employees to receive appreciation for a specified number of shares of the company where the settlement of such appreciation may be made by way of cash payment or shares of the company.

Restricted stock units: A sub-set of ESOPs, these are stock options that carry conditions/ restrictions for vesting/ sale.

As would be seen above, there are various types of stock based incentives, but for sake of simplicity, this article primarily focusses on ESOPs and only with reference to listed companies.

Companies Act provisions

Section 62(1)(b) of the Companies Act, 2013 provides that a company may, subject to compliance with conditions as prescribed under the Rules (in case of unlisted company) and SEBI Regulations[1] (in case of listed companies), offer shares to the employees under an Employees' stock option scheme. The primary requirement is obtaining shareholders' approval by way of a special resolution.

For the purposes of section 62 of the Companies Act, an "employee" includes employees of the company granting the option (whether working in India or outside) as well as employees of subsidiaries and holding company of the grantor company. Incidentally, Rule 12(c) of the Companies (Share Capital and Debenture) Rules, 2014 specifically exclude promoters or persons belonging to the promoter group and directors who directly or indirectly hold more than 10% of the outstanding equity shares of the company from being issued options. Further, Rule 12 of the Companies (Share Capital and Debenture) Rules, 2014 also mandates a minimum period of 1 year between the grant of options and their vesting.

In addition to the above, there are several compliances and disclosures prescribed by the Companies Act for a company issuing ESOPs.

SEBI Regulations

Downloaded by tanvi.shah@katalystadvisors.in at 02/03/21 03:37pm

taxsutra All rights reserved

ESOPs or other share-based incentives floated by listed companies are required to be in compliance with the relevant SEBI (Employee Share Based Payments) Regulations, 2014 ("SEBI Regulations") [these Regulations have replaced the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines that were made effective in 1999]. The SEBI Regulations, in addition to applying to the above-mentioned variants of share-based incentives, also apply to general employee benefit schemes and retirement benefit schemes. The definition of 'employees' under the SEBI Regulations (Reg. 2(1)(f)) has been aligned to that under the Companies Act.

For implementation of ESOP or other schemes, SEBI Regulations (Reg. 5) requires appointment of a Compensation Committee for administration of the said schemes. The role of the Compensation Committee (usually the Nomination and Remuneration Committee) is to formulate detailed terms and conditions of the schemes, including provisions specified by SEBI, and to frame suitable policies and procedures in order to ensure compliance under Prohibition of Insider Trading Regulations and the Prohibition of Fraudulent and Unfair Trade Practices Regulations.

A company may implement ESOP schemes ***either directly*** or ***through a trust***. While the company has the option to choose either of the routes, if the scheme involves secondary acquisition or a gift or both, then the scheme is mandatorily required to be implemented through a trust route only. Detailed regulations govern implementation of schemes through a trust which provide for various aspects ranging from who can be the trustees to conditions for secondary acquisition by the trust.

The SEBI Regulations (Regulation 17) provide the freedom of determining the exercise price (which can be less than the market price) but cannot be less than the face value of the relevant shares, to the company granting the options, subject to conformity with the accounting treatment prescribed in the Regulations. The Regulations prescribe accounting as per the Guidance Note on Accounting for employee share-based payments or the relevant Accounting Standard prescribed.

Accounting treatment

It is assumed that Ind AS applies and in this context, Ind AS 102 prescribes accounting treatment based on whether the employee incentive scheme is an equity settled plan or a cash settled plan.

ESOPs are generally equity settled plans. As per the provisions of Ind AS 102, the accounting treatment for equity settled plans prescribes recognition of the fair value of the stock option determined as expense in the Statement of Profit and Loss over the vesting period with corresponding increase in the equity. This aspect is captured in Para 7 and 8 of Ind AS 102 and can be illustrated by an example as follows:

A company grants 100 options each to 50 employees, with a vesting period of 2 years. Assuming the fair value of the option (computed as per an option pricing model such as Black Scholes Model) on the grant date is say, INR 40, the exercise price is INR 60 and the market price of the share (as on the grant date) is INR 110.

The company expects all 50 employees to exercise the option at the end of 2 years i.e. 5,000 shares (50 employees x 100 options) will be allotted. Therefore, the company's expense shall be INR 200,000 (5,000 options x INR 40 fair value of the option) to be recognised over the 2-year vesting period. The following entry will be passed by the company during the vesting period:

Employee compensation expense Dr INR 100,000

To Stock Options Outstanding INR 100,000

Upon exercise of the options by the employees and the allotment of shares, the company will receive INR 300,000 (5,000 options exercised x INR 60 exercise price) from the employees and the following entry will be made:

Bank a/c Dr INR 300,000

Stock Options Outstanding Dr INR 200,000

Downloaded by tanvi.shah@katalystadvisors.in at 02/03/21 03:37pm

taxsutra All rights reserved

To Share Capital INR 50,000

To Securities Premium INR 450,000

Ind AS 102 also provides guidance for determination of the fair value of options and the factors that need to be taken into account while using an options pricing model for computing the value of options as on the grant date. Some of the aspects that need to be considered include, *inter alia*, exercise price of the option, life of the option, current price of the underlying shares, expected volatility of the share price (especially in case of listed companies where several macro forces tend to have a bearing on the price in addition to the company's and industry's performance), etc.

Tax provisions for taxability of employees

Shares or securities allotted to employees under such incentive plans are covered as taxable perquisites under section 17 of the Income-tax Act, 1961 ("the ITA").

Section 17(2)(vi) of the ITA provides for the taxability of the perquisite on the exercised date on the difference between the value of the shares on the exercise date less the price paid in relation to such option exercised. This implies that if the employee exercises the option, he would have the shares in hand, but unless he sells the shares, he would not have the liquidity arising from shares and would still need to discharge the tax regardless.

The following table highlights the typical life cycle of stock incentive and its tax impact of each stage:

Particulars	Date	Tax Impact
Granting of options (10,000 shares for NIL consideration). FMV is Rs 500 per share.	April 1, 2019	No tax implications on the employee as well as the employer.
Vesting of options (10,000 shares for NIL consideration). FMV is Rs 525 per share.	October 1, 2020	No tax implications on the employee as well as the employer.
Exercise/Allotment of shares (10,000 shares for NIL consideration). FMV is Rs 600 per share.	March 31, 2021	Upon the exercise/allotment, Rs 60,00,000 (600 per share less 500 to be paid by the employee multiplied by 10,000 shares) will be taxable as perquisite in the hands of employees.
Subsequent sale of shares by the employee (Sold the shares for Rs 750 per share)	July 31, 2021	Upon subsequent sale of shares, Rs 15,00,000 (Rs 75,00,000 – Rs 60,00,000) will be taxable as capital gains in the hands of the employee. No withholding tax liability is triggered in the hands of the employer at this stage.

This provision of taxing the employees at the stage of exercise/ allotment of shares has resulted in significant cash flow issues for the employees. In such cases, the employees end up paying taxes on a notional gain and are forced to bear the tax burden without actually receiving any cash benefit at such time. The Finance Act 2020 took cognisance of this issue and amended section 192 of the ITA, which deals with tax deduction at source ("TDS") on income chargeable as "salaries". The amendment, in the form of insertion of sub-section (1C) to section 192 of the ITA, only provides relief to employees of start-ups (and not all companies) in the form of deferral of TDS on the perquisite value. As per the amendment, any start-up, referred to in section 80-IAC of the ITA, shall be liable to deduct tax on income

Downloaded by tanvi.shah@katalystadvisors.in at 02/03/21 03:37pm

taxsutra All rights reserved

being perquisite arising from ESOP or sweat equity shares within 14 days from the occurrence of any of the following events, whichever is earlier:

(i) expiry of 48 months from the end of the relevant assessment year i.e. the assessment year relevant to the year in which the option is exercised by the employee; or

(ii) sale of such specified security or sweat equity share by the assessee; or

(iii) employee ceases to be employed by the start-up.

However, in case of phantom or shadow equity, where the company notionally vests equity shares upon an employee at a particular price, and ultimately, as on a particular date, the employee is rewarded in cash on the basis of the difference between the allotment price, alluded to earlier, and the notional exercise price/ then prevailing market price, then such cash-incentive would be taxable only at the time of receipt of such incentive by the employee, unlike in case of a typical ESOP scheme.

Tax deductibility of cost borne by the employer

In the hands of the employer companies granting such ESOPs, there has been a controversy regarding the deductibility of the expenses borne by the company (in the form of the difference between the fair value of the shares and the exercise price) as to whether it can be claimed as a business expenditure under section 37 of the ITA. This issue has been discussed and appropriately allowed in several judicial precedents (including a recent judgment of Karnataka High Court, discussed in the ensuing paragraphs).

Biocon case Karnataka High Court judgement dated 11th November 2020 regarding tax deductibility

For employer, briefly, the facts of the case involved Biocon Ltd ('assessee') floating an ESOP scheme and administering it through a trust. The shares of the assessee were transferred to the trust at face value and options were given to the employees of the assessee to buy the shares within the time prescribed under the scheme. The assessee claimed the difference of market price and allotment price as discount and claimed deduction under section 37(1) of the ITA.

The High Court observed that there is no requirement of pay out of expenditure under section 37, nor does it envisage incurrence of expenditure in cash. Further, the High Court, relying on Supreme Court decision in case of Bharat Earth Movers[2] and Rotork Controls India P. Ltd[3], held that discount on issue of ESOPs is not a contingent liability but is an ascertained liability. Karnataka High Court also held that, the expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount, where the assessee absorbs the difference between the price at which it is issued and the market value of shares, would also be an expenditure incurred for the purposes of section 37(1) of the ITA.

It may be worthwhile to note that in the afore-mentioned case of Biocon Ltd, the ESOP scheme was subject to SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999. While the said Guidelines have been replaced by the SEBI (Share Based Employee Benefits) Regulations of 2014, the principle of determining the fair value of options granted by listed companies based on the market price of the shares as on the grant date continues to be the same.

Summing up

ESOPs and other employee incentive plans continue to be an effective mode of attracting and motivating employees. However, given the compliance-ridden world that we live in, and considering the inter-twining of various laws and regulations governing these incentive plans, it becomes imperative for companies to bear in mind all the aspects involved. The Karnataka High Court's decision in the case of Biocon Ltd is a very welcome ruling and the CBDT should accept the principle laid down expressly by providing a clarification, accepting the decision; it is clearly logical that the implied cost should be deductible and in the interest of Ease of Doing Business, proactive action by CBDT providing clarification to this effect would be very welcome.

---

[1] SEBI (Employee Share Based Payments) Regulations, 2014

Downloaded by tanvi.shah@katalystadvisors.in at 02/03/21 03:37pm

taxsutra All rights reserved

[2] Bharat Earth Movers (2000) [TS-5116-SC-2000-O] (SC) dated 9 August 2020

[3] Rotork Controls India Pvt Ltd (2009) [TS-111-SC-2009-O] (SC) dated 12 May 2020

Downloaded by tanvi.shah@katalystadvisors.in at 02/03/21 03:37pm