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TAXATION

ESOPs and SARs – A Comparative Guide

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1. What are Employee Stock Options Plans (ESOPs) and Stock Appreciation Rights (SARs)?

- **ESOPs** are a stock option provided by a company to its employees, to purchase its shares on future dates and at a pre-determined price. They are basically a form of incentive given out by a company to its employee basis their contribution to the company. Further, such an incentive helps the company to motivate its employees to contribute to the growth and profitability of the company in future as well.

  ESOPs are defined under Section 2(37) of Companies Act, 2013 (**CA 2013**) and are governed by Section 2(37) read with Section 62(1)(b) of CA 2013 along with Rule 12 of the Companies (Share Capital and Debentures) Rules 2014.

  There is a minimum vesting period of one year between the grant of options and vesting of option, as per the Regulation No 9 of the SEBI Guidelines, 1999 further, it is to be noted that, as such, there is no such lock-in period involved in ESOPs and the issuing company/employer is at liberty to specify the lock-in period for the shares issued pursuant to exercise of option.

- **SARs** are instruments issued and used by a conglomerate for making stock-based compensation. SARs are alternatives to Employee Stock Option/Purchase Plans/Schemes (**ESOPS/ESPS**), which are equity based. It may also be called a form of bonus compensation given to employees that is equal to the appreciation of company stock over an established time, but without employee being paying the exercise price.

  Depending on the contractual terms of the respective employee with his employer, SARs are of can be following two types 'equity settled' and 'cash settled'. SARs which are settled by way of shares of a company are called as equity settled SARs whereas a SAR which entitles an employee the right to receive cash payments after a specific period of time or upon fulfilment of specific criteria is called as cash settled SARs.

  A company is needed to make a provision in its P&L account each year, depending on how the price of shares vary each year, but this option of compensation to employees may not be suitable to companies which are not cash rich. While the CA 2013 has prescribed rules for issuance of shares to employees under Stock Plans, it is silent on the grant and exercise of SARs including issuance of equity settled SARs and Phantom Stock Options or Cash Settled SARs.

  The companies by issuing SARs contemplate to pass on the appreciation in the value of a certain number of equity shares to their employees in the value of a certain number of equity shares to their employees, unlike ESOPs. The company is also saved from diluting its rights as a result of which its shareholding remains unaltered. The primary benefit to the employee, that comes with SARs, is that the employee can receive proceeds from stock price increases without being required to buy anything outright.

2. What are the stages involving the process of issuance of ESOPS? What are the key phases relating to SARs?

Stage	ESOPs	SARs
Option	An option is granted to an employee, to purchase the shares of the company. Such an option is based on the fulfillment of the conditions mentioned in the ESOP plan. The price is decided at this juncture.	N.A.
Grant	The eligibility of an employee (depending on the criteria set) for grant of stock options based on his role and performance is known as grant of option	The cash bonus is paid based on how much the stock has increased over the grant price. The grant price is usually the fair market value on the date the appreciation rights were granted.
Vesting	Vesting is the entitlement of the option to an employee. Before exercise of the option, the employee must wait for a limited period as a condition of grant of ESOP.	It represents the period during which the vesting conditions are to be fulfilled, and it starts from the grant date.
Exercise	Exercise is the activity of converting the stock options granted to an employee into shares by paying the required exercise price, i.e., allotment. Companies have the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.	This is the period during which the participants must exercise their SARs. It starts after the vesting period ends and runs until the expiry date.
Expiry	N.A.	This is the date when the scheme ends. Beyond this period, no SARs can be exercised by the participants.

3. Which provisions of Income Tax Act, 1961 govern ESOPs and SARs transactions?

ESOPs

Prior to the Finance Act, 2009, ESOPs were covered under the Fringe Benefit Tax (**FBT**), but thereafter they have been made taxable at the hands of the employee as 'perquisites', subject to certain conditions.

Relevant provisions under the ITA, which deal with ESOPs and gains from their redemption are set out as under.

- **Section 17 – "Salary", "perquisite" and "profits in lieu of salary" defined.**
  - **(2)(iii)** the value of any benefit or amenity granted or provided free of cost or at concessional rate in any of the following cases—
    - (a) by a company to an employee who is a director thereof;
    - (b) by a company to an employee being a person who has a substantial interest in the company;
    - (c) by any employer (including a company) to an employee to whom the provisions of paragraphs (a) and (b) of this sub-clause do not apply and whose income under the head "Salaries" (whether due from, or paid or allowed by, one or more employers), exclusive of the value of all benefits or amenities not provided for by way of monetary payment, exceeds fifty thousand rupees:
  - **(2)(vi)** the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

    Explanation – For the purposes of this sub-clause -
    - (a) "specified security" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and, where employees' stock option has been granted under any plan or scheme therefor, includes the securities offered under such plan or scheme;
    - (b) "sweat equity shares" means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called;

- (c) the value of any specified security or sweat equity shares shall be the fair market value of the specified security or sweat equity shares, as the case may be, on the date on which the option is exercised by the assessee as reduced by the amount actually paid by, or recovered from, the assessee in respect of such security or shares;
- (d) "fair market value" means the value determined in accordance with the method as may be prescribed;
- (e) "option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price;

- **Section 49 – Cost with reference to certain modes of acquisition.**
  - **(2AA)** Where the capital gain arises from the transfer of specified security or sweat equity shares referred to in sub-clause (vi) of clause (2) of section 17, the cost of acquisition of such security or shares shall be the fair market value which has been taken into account for the purposes of the said sub-clause.
- **Rule 1(iii) of Scheme dated 11-10-2001 bearing no SO 1021E**
  - **ESOP/Scheme:** "Plan/Scheme whereby an employee of the company is given option to acquire shares of the company at a pre-determined price after a certain period, directly or indirectly through a trust."

It is pertinent to note that, in the instance that the ESOPs are granted by a foreign entity to an Indian resident, the said transaction would also be taxable in India. The foreign entity can take advantage of double taxation avoidance agreement entered between the India and the country of its residency. The said position is confirmed by Authority for Advance Ruling (**AAR**) in the case of *Microsoft Corporation, USA*[1]

SARs

SARs relating to listed entities are regulated by SEBI (Share Based Employee Benefits) Regulations, 2014 whereas SARs of unlisted companies are governed by Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014.

As per the SEBI (Share Based Employee Benefits) Regulations, 2014, SARs is defined as under:

A right given to a SAR grantee entitling him 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.

Further, any income received by an employee, in the form of cash entitlement at the time of the exercise of Phantom Stock Options like SARs, is taxed as per Section 17(2)(vi) of the ITA read with Rule 3(8)/(9) of the IT Rules as perquisites in the hands of the employee. No incidence of the tax arises in hands of the company/employer at the time of making payment of the cash entitlement to the employee. The amount received from the redemption of SARs can only be treated as 'capital gains' as per Section 28 of the ITA.

4. How are taxes calculated on recipients of ESOPS and SARs?

ESOPs

According to Sections 17(2)(vi) and 49 (2AA) of the ITA, shares bought as part of an ESOPs, can attract taxes twice i.e. once upon purchase and thereafter on sale. The aforesaid depends on various factors & employer-employee contract.

- **First Levy:**

  At the time of allotment of shares on the exercise date, the difference between FMV of the shares as on exercise date and the amount that employees have paid for the exercise or subscription to the shares is calculated and taxed accordingly. This taxable value is called perquisite value. Upon allotment of shares after the employee exercises his option on the completion of the vesting period and the employer will have to compute the perquisite value of ESOP taxable in the hands of the employee under "income from salary" 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 and treated as income from salary in the tax return.

- **Second levy:**

  When employee opts to sell the shares previously allotted under the ESOP, the profits made by him are taxed as capital gains under Section 45 of the ITA. The period of holding shall be computed from the date of allotment of such shares as per Section 2(42A) of the ITA. Capital gains are calculated by subtracting the FMV as on the exercise date from the sales consideration of such shares.

  In case of a listed company, if shares are held for more than 12 months, it will be considered as long-term capital gains and will be taxed under Section 112A at 10% plus 4% health and education cess.

[1] [1999] 235 ITR 565 (AAR)

However, capital gains up to INR 1,00,000 in a single financial year, are exempt from tax If shares are held for less than 12 months, it will be considered as short-term capital gain and profit will be taxed at 15% Section 111A.

In case of start-ups and unlisted companies, the shares will be considered short-term assets if they are held for less than 24 months from the exercise date and taxed according to the respective tax slab. If the shares are held for more than 24 months, and sold after this period, these are considered as long-term gains and taxed at 20% after indexation of cost.

Further there will be a deduction of tax at source as per Section 192 of the ITA. Moreover, in case of unlisted company Section 17(2) read with Rule 3(8)(iii) of the IT Rules, 1962 which provides that for the purpose of calculating perquisite value, the FMV of ESOPs shall be such value as determined by a merchant banker on the specified date. Specified Date means the date of exercising of the option; or any date earlier than the date of the exercising of the option, not being a date, which is more than 180 days earlier than the date of the exercising. In the event, the employee chooses to not exercise his option, there shall be no tax implication for the employee.

SARs

Fair Market Value (**FMV**) of shares or securities on the date of exercise of option by the assessee less amount recovered from the employee in respect of such shares shall be the taxable value of perquisites. Fair Market Value shall be determined as follows:

- **In case of listed Shares:** Average of opening and closing price as on date of exercise of option (Subject to certain conditions and circumstances)
- **In case of unlisted shares/security other than equity shares:** Value determined by a Merchant Banker as on date of exercise of option or an earlier date, not being a date which is more than 180 days earlier than the date of exercise of the option.

Please note that the Finance Act, 2020 has deferred the taxation of perquisite in case of start-ups from date of allotment to the earliest of the following three dates:

- Expiry of 48 months from the end of the relevant assessment year;
- Sale of such shares by the employees;
- Date on which employee ceases to be employee of the start-up.

The eligible start-up shall, accordingly, be required to deposit tax with the government within 14 days of the happening of any of the above events (whichever is earlier). However, Section 17(2)(vi) of the ITA, has not been amended, thus the income shall be computed in the year in which shares are allotted but tax shall be paid in subsequent year.

Lastly, Section 192 of the ITA puts an obligation on an employer to deduct tax at source on perquisite income. Tax must be deducted when the SARs are actually exercised.

5. How will the employer/company be taxed in case of issuance of ESOPs? Can an employer claim expenses incurred in issuing SARs as deduction while filing income tax returns?

ESOPs

A company issuing ESOPs, can claim its costs as a deduction. The discounts provided by an employer, while issuing ESOPS, amounts to employee cost and can be claimed as a deduction over the vesting period, in its the hands. The same is allowed as per Section 37of the ITA. Such expenses can also be amortized as ***per SEBI (Employee Stock Option Scheme & Employee Stock Purchase Scheme) Guidelines, 1999***. A discount on ESOPs is a general expense and not covered under any other provisions and hence is deductible, as per Section 37(1) of the ITA, during the vesting period with regards to, the market price of shares at the time of grant of options to the employees.

It is pertinent to note that in the matter of Lemon Tree Hotel[2], the Delhi High Court has settled the law in favor of Employer Assessee and has confirmed that expenses incurred to for the purposes of Business/Profession and has been debited in P&L Account shall be allowed to be deducted while computing taxable income. Further, the quantum of deduction has to be allowed for a sum determined on some rational basis representing the amount of liability incurred, as held by Income Tax Appellate Tribunal, Bengaluru in the case of Biocon Ltd[3].

[2] ITA No. 107/2015) (Del HC)
[3] ITA No.368/Bang/2010

Tax implication on buy-back: An employer can buy-back the shares issued by it as per Section 68 of the Companies Act, 2013. Although, there is no bar to buy back, there can be certain tax implications under the ITA. Upon buying back of shares by an unlisted company, Sections 10(34A) and 115QA of the ITA get triggered. Section 10(34A) of the ITA is set out as under:

As per section 10(34A) of the ITA, any income arising to a shareholder (including ESOP-shares) on account of buy back of unlisted shares by the company shall be exempt in the hands of such shareholder.

Further, as per Section 115QA of the ITA, tax at 20% plus surcharge at 12% plus health and education cess at 4% shall be paid by the unlisted company on the buyback of its shares. It is pertinent to note that vide Finance Act, 2019, the provisions of Section 115QA of the ITA were amended and have thereby been made applicable to the listed companies.

SARs

Although the law does not specifically envisage the deductibility of SARs expenses in the hands of the company, such expenses are allowable under Section 37 of the ITA. These expenses are revenue expenditures.