

## EMPLOYEE STOCK OPTION PLAN

# ESOP





Employee Stock Option Scheme

Employee Stock Purchase Scheme



Stock Appreciation Rights

General Employee Benefits Scheme

Retirement Benefit Schemes

# Decoding ESOPs

## EMPLOYEE -

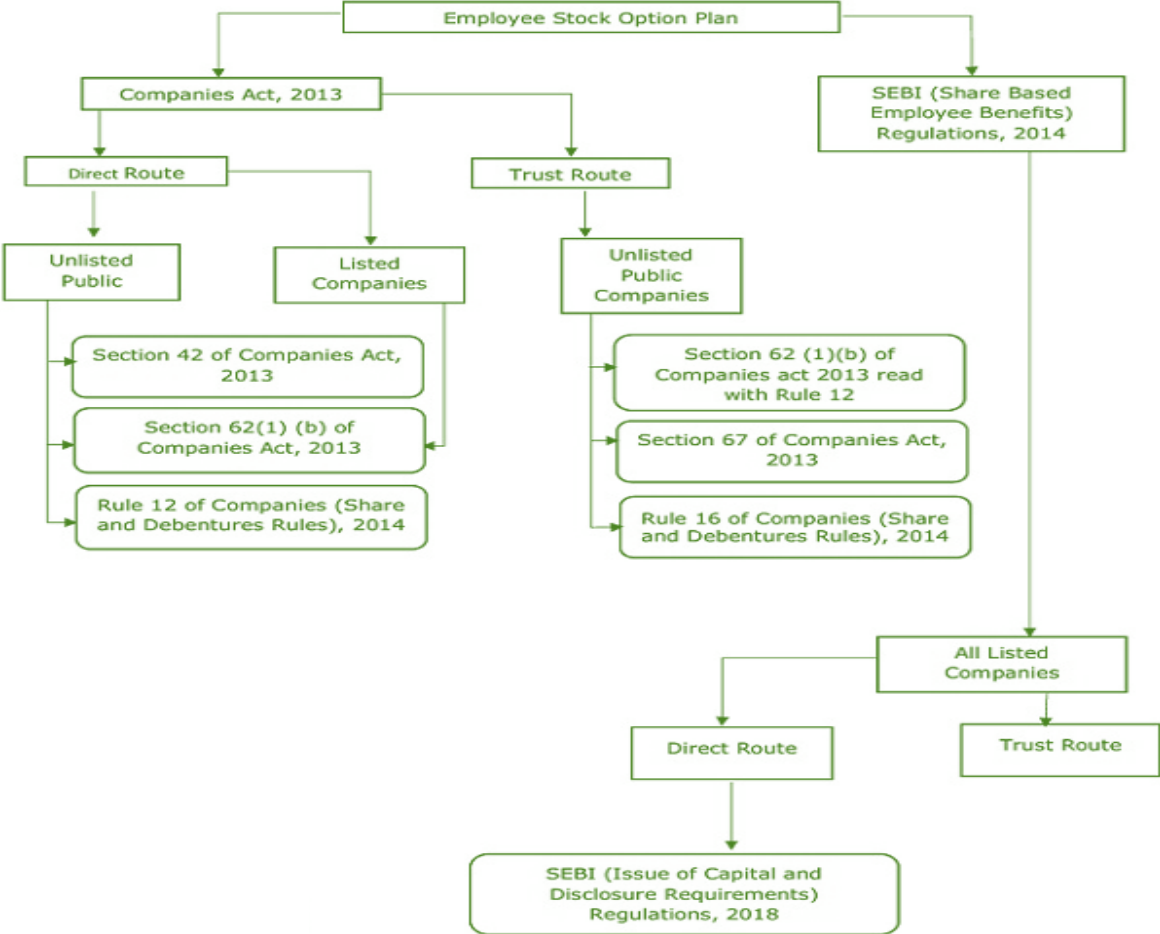
<p>Include</p> 	<ul style="list-style-type: none"> <li>• A <b><u>PERMANENT EMPLOYEE</u></b> of the company who has been working in India or outside India; or</li> <li>• A <b><u>DIRECTOR</u></b> of the company, whether a whole time director or not; or</li> <li>• An <b><u>EMPLOYEE</u></b> as defined in clause (a) or (b) of a <b><u>SUBSIDIARY</u></b>, in India or outside India, or of a <b><u>HOLDING COMPANY</u></b> of the company or of an <b><u>ASSOCIATE COMPANY</u></b></li> </ul>
<p>Exclude</p> 	<ul style="list-style-type: none"> <li>• <b><u>INDEPENDENT DIRECTOR</u></b></li> <li>• An employee of subsidiary company, holding company or associate company: who is a <b><u>PROMOTER</u></b> or a person belonging to the <b><u>PROMOTER GROUP</u></b>; or</li> <li>• A director who either himself or through his relative or through any corporate, <b><u>DIRECTLY OR INDIRECTLY</u></b>, holds <b><u>MORE THAN 10%</u></b> of the outstanding equity shares of the company.</li> </ul>

<b>STOCK -</b>	<b>OPTION -</b>	<b>PLAN -</b>
<p><b><u>EQUITY SHARES</u></b> of the Company</p>	<p><b><u>RIGHT BUT NOT AN OBLIGATION</u></b> to purchase the Equity Shares of the Company</p>	<p><b><u>AT A PRE-DETERMINED RATE ON A PRE-DETERMINED TIME ACCORDING TO POLICY</u></b> to purchase the Equity Shares of the Company</p>

## Privilege to START-UPS

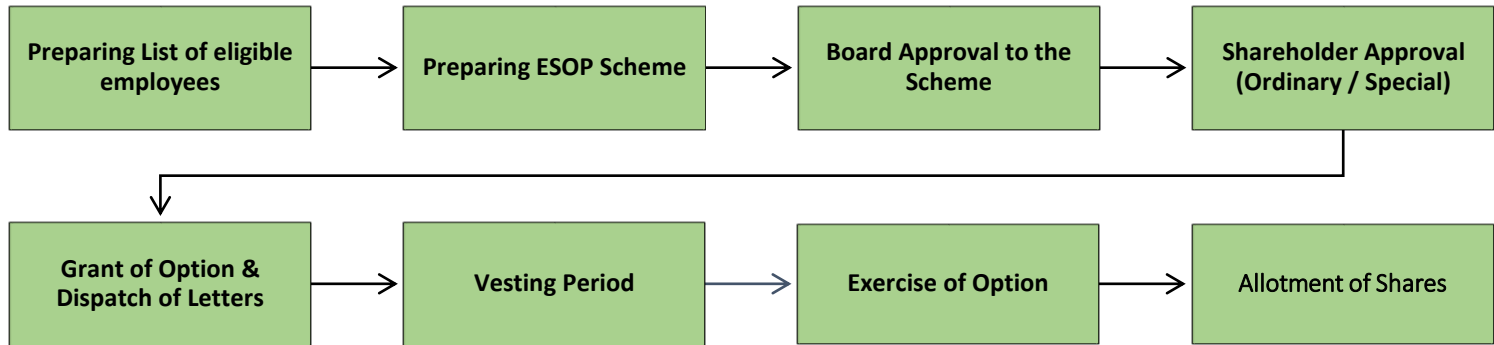
- In order to promote startups, the Ministry of Corporate Affairs vide Notification dated 19.07.2016 issued the [Companies \(Share Capital and Debentures\) Third Amendment Rules, 2016](#) wherein it was provided that Startups MAY ISSUE the shares under ESOP to their PROMOTERS AND DIRECTORS who hold more than 10% FOR THE FIRST 5 YEARS from the date of their incorporation.
- The restriction on issuing shares under ESOP to promoters and such directors continues for companies which does not fall under the category of startups.

# LEGAL PERVIEW

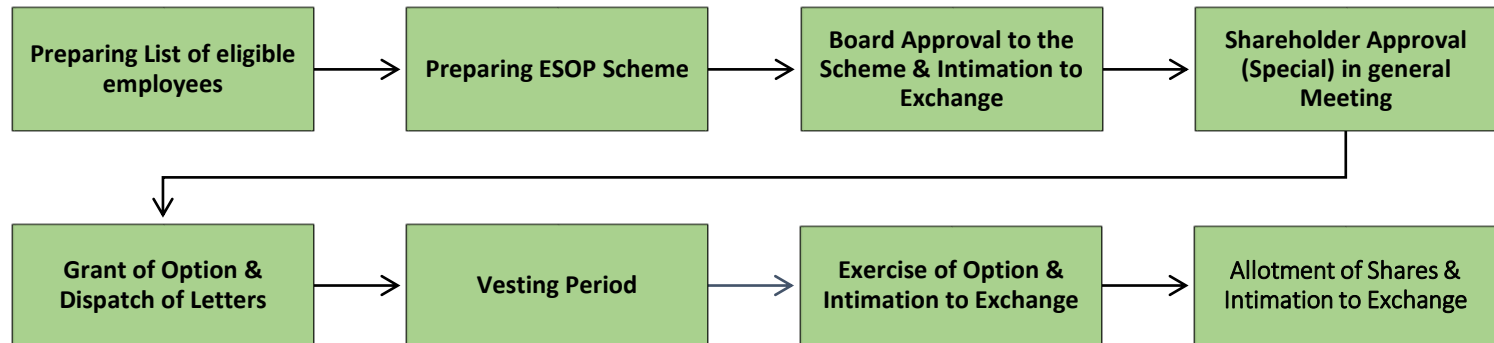


# Procedure for ESOPs

## PRIVATE / UNLISTED PUBLIC COMPANY



## LISTED COMPANY

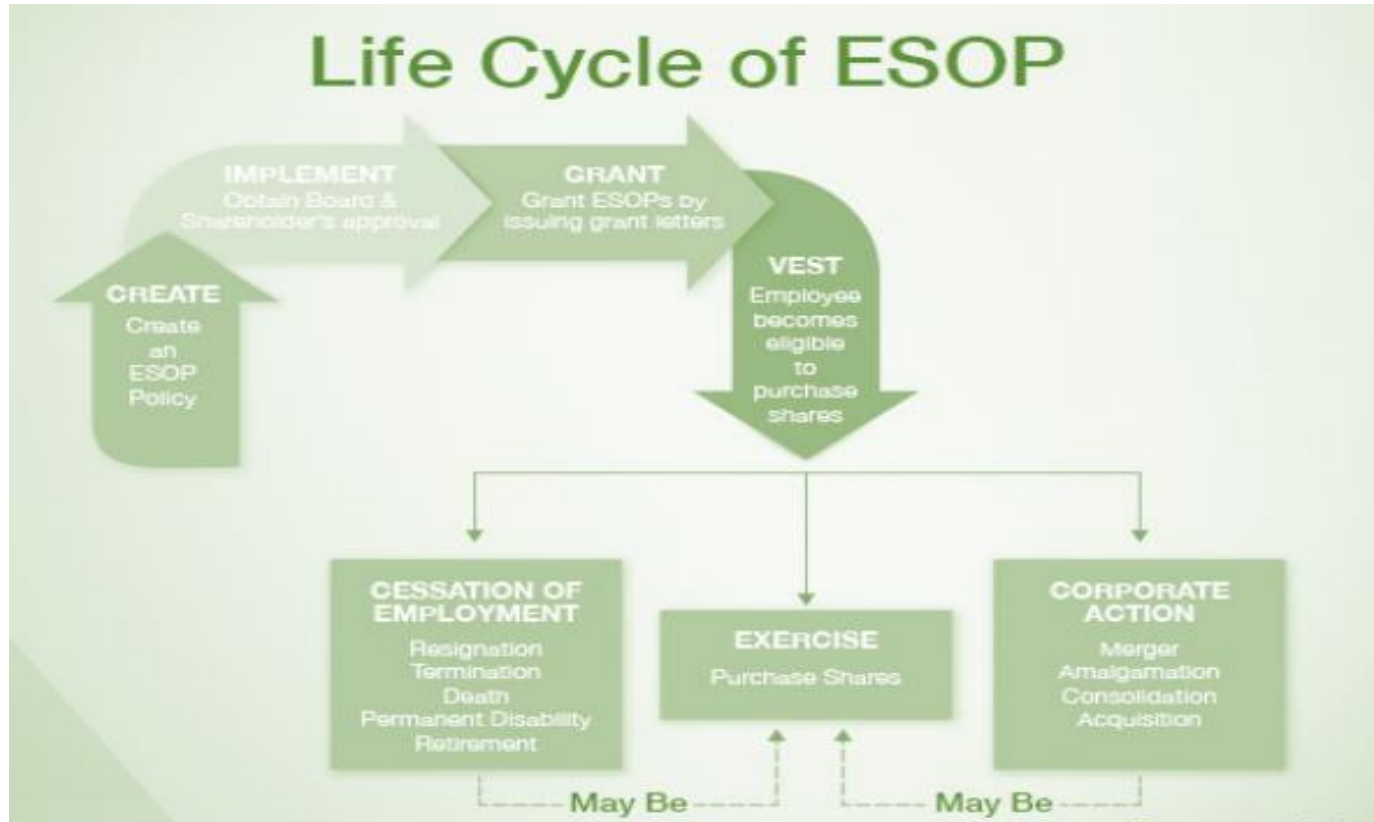


# Disclosure of ESOPs

*The company shall make the following disclosures in the explanatory statement annexed to the notice for passing of the resolution:*

- the total number of stock options to be granted;
- identification of classes of employees entitled to participate in the Employees Stock Option Scheme;
- the appraisal process for determining the eligibility of employees to the Employees Stock Option Scheme;
- the requirements of vesting, period of vesting and the maximum period within which the options shall be vested;
- Exercise Price/Pricing Formula/Exercise Period/Method of valuation;
- the Lock-in period, if any;
- the maximum number of options to be granted per employee and in aggregate;
- the method which the company shall use to value its options;
- the conditions under which option vested in employees may lapse e.g. in case of termination of employment for misconduct;
- the specified time period within which the employee shall exercise the vested options in the event of a proposed termination of employment or resignation of employee;
- a statement to the effect that the company shall comply with the applicable accounting standards.

# LIFE CYCLE OF ESOP





## PRIVATE / UNLISTED PUBLIC COMPANY

**For the purpose of accounting** - valuation is required to determine the intrinsic value / fair value of the Stock Options at the date of grant of the options. So, the Company must seek a valuation on the grant date to record the cost of the stock options in its books of accounts.

**For the purpose of determining income and taxes** - an Unlisted Company needs to determine the fair market value of the shares at the time of exercise so it needs to seek a valuation of its shares on the exercise date.

At the time of **GRANT OF OPTION**, valuation of fair value of shares shall be done by **REGISTERED VALUER**.

At the time of **EXERCISE OF OPTION**, valuation shall be done by **MERCHANT BANKER**.

## LISTED COMPANY

**For the purpose of accounting** - valuation is required to determine the intrinsic value / fair value of the Stock Options at the date of grant of the options. So, the Company must seek a valuation on the grant date to record the cost of the stock options in its books of accounts.

**For the purpose of determining income and taxes** – Listed Company shall consider the price quoted on recognized stock exchange at the time of exercise of the option, for this purpose.

# IMPORTANT TERMINOLOGIES

- **Grant:** Grant means the issue of stocks to the employees. It means informing the employee that he is eligible for ESOP. The company will have the freedom to determine the exercise price while providing the option of ESOP to the employees.
- **Vest:** Vest means the right of the employees to apply for the shares granted to them. There shall be a minimum of one year between the grant of option and vesting of option for the ESOP scheme.
- **Exercise:** The exercise period is where the employees can exercise the option of buying the shares. The company will have the freedom to specify the lock-in period for the shares issued (if any) after the exercise of the option. The employees will not have the right to receive any dividend or to vote or enjoy the advantages of a shareholder in respect of the ESOP granted to him until the shares are issued on exercise of his option.
- **Vesting Conditions:** These are the conditions that must be satisfied for the employee to become entitled to receive cash or shares pursuant to an employee share-based payment plan.
- **Vesting:** It is the process by which the employee is given the right to apply for shares of the company against the option granted to him in pursuance of employee stock option scheme.
- **Vesting Period:** It is the time period between grant date and the date on which all the specified vesting conditions of an employee share-based payment plan is to be satisfied.

# IMPORTANT TERMINOLOGIES

- **Exercise Period:** It is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the ESOS.
- **Exercise Price:** It is the price payable by the employee for exercising the option granted to him in pursuance of ESOS.
- **Expected Life of an Option:** It is the period of time from grant date to the date on which an option is expected to be exercised.
- **Grant Date:** It is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained.
- **Intrinsic Value:** It is the excess of the market price of the share under ESOS over the exercise price of the option (including up-front payment, if any).
- **Fair Value:** It is the amount for which a stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

## PROS

- Can be treated as a retainer ship instrument
- Gives employees an ownership feeling
- Can be used as substitute of salary cost
- Non-cash compensation tool
- 0 effects on Cash Flow

## CONS

- Dilution of promoter holding
- No Marketability of the shares
- Risk of increased public holding
- Liquidity benefit is highly uncertain
- No clear guidelines for Valuation

## For the Employee

### Stage 1 (Perquisites)

- Upon allotment of shares after the employee exercises his option on the completion of the vesting period. Upon allotment of shares, 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.

### Stage 2 (Capital Gains)–

- When the shares allotted to the employee are sold by him. If the company is listed on an Indian stock exchange and shares are held for more than 12 months, it will be considered as long-term capital gain and as per Finance Act 2018, it will be taxed u/s 112A at 10% exceeding Rs. 1 lakh of CG. 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% u/s 111A.
- For Start-ups, such shares will be considered short-term assets if 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.



## For the Employer

### Tax Deduction

- The Issuing Company can claim ESOP cost as deduction;
- The discounts under the ESOP are an employee cost and should be allowed as a deduction over the vesting period, in the hands of the issuing company.

### ESOP Buy Back

- As per section 10(34A), 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, the tax @ 20% shall be paid by the unlisted company on the buyback of its shares.

## Infosys

Infosys has been a pioneer in ESOPs in India. It has created billionaires in India through its ESOPs

**N**arayana Murthy's chauffeur and personal assistant know the value of an employee stock option. The employees of the Infosys' founder-CEO were part of the over 2,000 employees who received ESOPs from the company that turned them into overnight millionaires when the company's shares were quoting at Rs. 7,500 in the early 2000s.

Courtesy: <https://www.forbesindia.com>

## Infosys gives ESOPs worth Rs 40 crore to CEO Salil Parekh, others

Courtesy: <https://economictimes.indiatimes.com>

## Recent ESOPs

The IPO of IndiaMART in July 2019 resulted in its ESOP-privileged employees earning millions. The company offered 4.89 million shares (at a face value of INR 10 each) on the NSE & BSE, and the issue price of each share was listed at INR 970-973. 10,000 shares were reserved for employees at a discount of INR 97 per share. The stock shot up 40% on listing and today the stock is trading above INR 2000 per share.

A similar trend was observed when JustDial, QuickHeal, Info Edge, and Matrimony.com went public.

## Recent ESOP specific Actions

Bangalore-based online freight aggregator BlackBuck bought back some ESOP shares from employees. 35 employees sold back their stock options at a price much higher than the Fair Market Value.

The company's senior HR management mentioned in a public release that BlackBuck bought back the shares to restructure its ESOP pool.



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