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CONCEPT OF EMPLOYEE STOCK OPTION PLAN – USAGE AND OBJECTIVE

INTRODUCTION

Employee Stock Option Plans (ESOP), which were formerly unheard of in India, have grown in popularity by great strides in recent years. The importance of ESOPs was, at first, realized by the IT companies and businesses as a means of attracting and retaining top personnel. Employee stock ownership plans are typically used by companies as a business finance tactic to line up the interests of their employees with that of their shareholders.

Section 2(37) of the Companies Act, 2013[1] defines 'employee's stock option' as the benefit or right offered to directors, officials, or employees of a company or its parent company or subsidiary firm or companies, if there are any, to own, or sign up for, the company's shares at a future period at a pre-determined value. In other words, ESOPs recognize and reward the high-performing employees of the company with an ownership interest or a cash settlement based on

[1] "employee's stock option" means the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price

an equity stake, which further motivates and incentivizes them for better performance in the future.

REGULATIONS IN INDIA FOR ESOPs

In November 1997, the Securities and Exchange Board of India (SEBI) established a committee led by Prof. J.R. Varma to evaluate and review current ESOS legislation and make recommendations. SEBI has issued the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines in response to the Committee's findings. These regulations came into effect on June 19, 1999. These guidelines would only apply to corporations whose stock is traded on any recognised stock exchange in India.[2]

However, in 2013, SEBI limited the scope of ESOPs' use by prohibiting listed companies from purchasing their own equity on the secondary market.

As per provisions of Sec 62(1) (b) of Companies Act, 2013[3], when a company with a share capital seeks to grow its subscribed capital by issuing additional shares; such shares are offered to the employees under a scheme of employee stock option, which is subject to the company's special resolution and any conditions that may be imposed.

The legal foundation for the issuing of ESOPs for unlisted firms is laid forth in Rule 12 of the Companies (Share Capital & Debentures) Rules, 2014. The SEBI (Share Based Employee Benefits) Regulations, 2014 ("ESOP Regulations") apply to listed businesses with ESOP programmes.

WHO CAN EXERCISE THE OPTION

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[2] Section 3.1 of the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme), Guidelines, 1999, "*These Guidelines shall apply to any company whose shares are listed on any recognised stock exchange in India.*"

[3] "Where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered to employees under a scheme of employees' stock option, subject to special resolution passed by the company and subject to such conditions as may be prescribed."

Employees of an organisation's holding company and subsidiary companies can be given options. The Subsidiary Company might be a domestic or international corporation, but the Parent Company must be based in India. Permanent workers working in India or abroad, as well as directors who are full-time or part-time, are encompassed under the definition of employee[4], and can thus be offered stock options under an Employee Stock Option Scheme (ESOS).

The promoter of the company or a member of the promoter group is not authorized to obtain options under the ESOS.[5] Also, a director who actively or passively owns more than 10% of the firm's outstanding equity shares, whether by oneself, through their family, or through an investment business, shall be unable to participate in the ESOS[6]. Options are not given to the company's non-employee service providers, such as advisers or lawyers.

The recent improvements to Rule 8 of the Share Capital and Debenture Rules allow a start-up company to offer sweat equity shares up to 50 percent of its paid-up capital, up to ten years from the date of its establishment or formation.

It must be noted that it is not at all compulsory for the employees to accept such offers made to them. It is a mere option provided to them.

HOW ESOPs WORK

The first step in the mechanism of ESOPs is the Grant of Options where the Company issues options to qualifying employees under the ESOP. If the option holder meets specific criteria, the option can be converted to shares. These are known as the "vesting requirements," and they can be either a number of years of continued employment after acquiring the option, or the option holder's achievement of certain performance goals, or both. The options are said to be "vested[7]" once the vesting criteria are met.

[4] Section 2.1(1) of the Guidelines
[5] Section 4.2 of the Guidelines
[6] Section 4.3 of the Guidelines
[7] "Vesting means the process by which the employee is given the right to apply for shares of the company against the options granted to him in pursuance of the employee stock option scheme." As defined in section 2.1(15) of the Guidelines

There must be a minimum gap of one year between the issuance of the option and the vesting of the option. Vesting can happen all at once or in a series of sequential strokes.

A vested option grants the option holder the unrestricted right to "exercise" the option and receive company shares. However, if the employee is fired for misbehavior, his vested options may also be forfeited. The process of converting a vested option into shares by paying the exercise price is known as exercise. The exercise price is usually decided when the employee is given the option. Until he exercises his option and is assigned shares, the option holder is not permitted towards any dividends or voting rights.

COMPENSATION COMMITTEE

Section 5 of the guidelines, 1999 prescribes the formation of a compensation committee for management and superintendence of ESOPs. The Compensation Committee, a committee of the Board of Directors, shall consist of a majority of independent directors and is responsible for drafting the ESOPs comprehensive terms and conditions, among other things. The Committee is responsible to ensure and draft such policies so that there is no violation of SEBI Guidelines and other laws.

TRANSFERABILITY OF ESOPs

By law, Employee stock options are not convertible, and only the employee has the right to exercise them. In no way can the options be pledged, hypothecated, mortgaged, or otherwise alienated. The Guidelines make an exception to this general rule, stating that if an option holder dies while employed, any options granted to him, including unvested options, will vest in his legal heirs on the day of his death, and they will be able to exercise the options. If he was not an employee at the time of his death, all of his vested options will be transferred to his legal heirs, who will be able to exercise them. These conditions are stated in Rule 12(8) of the Companies (Share Capital and Debentures) Rules, 2014.

SPECIAL RESOLUTION

Rule 8 obligates that the issuing of sweat equity shares at a reduced price or for consideration apart from cash, to its directors or employees for giving know-how or providing available rights in the nature of intellectual property or value additions, requires the approval of shareholders via a special resolution.

It provides that a business should not offer sweat equity stock worth over 15% of its total paid-up equity share capital or shares with an issue value of 5 crores or more in one year period, whichever is greater, provided that the issuing of sweat equity shares in the company will not outstrip 25% of its total paid-up equity share capital at any point.

Rule 8 also mandates a number of administrative requirements, including the keeping of registers, obligatory disclosures in directors' reports, and the accounting handling of sweat equity plans. Furthermore, Rule 8 requires that the value of sweat equity shares to be issued to employees and directors be assessed at a reasonable price by an authorized valuer who provides a rationale for the assessment. The sweat equity shares awarded to employees or directors must be locked in for a period of three years from the date of allotment, according to this rule, which includes detailed valuation criteria.

TAXATION ASPECT

Up till March 1999, there were no formal procedures for taxation of ESOP benefits. It was the difference between the FMV of the stock on the date of vesting of the options and the exercise price that was generally taxed as a perquisite in the hands of the employees. Following that, ESOPs that were designed in conformity with the mandated ESOPs Guidelines received preferential tax treatment. For such qualifying ESOPs, taxes begin only at the time of the sale of the shares.

As of now, ESOP perks are taxable as a perquisite and are included in the employee's compensation as part of it. In the case of such perquisites, the company is expected to withhold tax at the source. The difference between the FMV of the share on the day of exercise and the exercise price is used to calculate the value of the perquisite. In addition, the employer is required to deduct TDS on such perquisites.

The sale of shares issued to employees under an ESOP is subject to capital gain taxation. The difference between the sale price and the exercise price will be recognised as a capital gain or loss, and the timeframe from the date of option exercise to the date of sale of Shares would be considered the holding period. The gain will be regarded as LTCG (Long Term Capital Gain) if the shares are held for more than 24 months; otherwise it will be handled as STCG (Short Term Capital Gain).

However, it can be argued that in the case of global ESOSs, there is no employer-employee relation between the parent (group) firm providing the options and the Indian residential personnel of the Indian company. But, by lifting the corporate veil in the case of Microsoft Corp. US[8], India's Authority for Advance Rulings ('AAR') determined that the foreign parent corporation and the Indian subsidiary should be treated as one entity and that stock options conferred by a foreign company to employees of its wholly-owned Indian subsidiary will be chargeable to tax in India. It was also held that when employees exercise their option, the difference between the exercise price and the market price is taxable as salary in the hands of the employees.

TYPES OF ESOPs IN INDIA

1. Employee Stock Option Scheme:

An ESOP Scheme is a plan in which the employees are given the option to purchase shares at a predetermined price. The employee has the right, but not the responsibility, to exercise the options offered under such a plan. Stock options are subject to vesting conditions, which usually entails ongoing employment for a set length of time. Employees can exercise their options to obtain shares in the company once they have vested, by paying the pre-determined exercise price. Employees are frequently given loans for this purpose by their employers. In this type of ESOP, the employee becomes a shareholder of the company when the option is exercised.

[8] [1999] 102 Taxman 74 (AAR).

2. Employee Stock Purchase Plan:

Employee stock purchase plans allow employees to buy stock from the company directly. The acquisition is usually made at a lower price than the actual market value at the time the grant or exercise is made. The circumstances, date, and rate at which the employee is eligible to buy the shares are outlined in such schemes. In this type of ESOP, the employee becomes a shareholder of the company after purchasing shares. We've noticed that firms occasionally provide loans to employees who want to buy stock through employee stock purchase schemes.

3. Restricted Stock Award:

An employee receives an award of a particular number of shares under a restricted stock award plan, which is subject to certain restrictions. In such programmes, the employee has ownership rights over the shares from the date of the issuance, with the right to dividends and the right to vote. If the award's requirements aren't met, the shares will be forfeited. Until the prerequisites are fulfilled, the shares may not be delivered to the employee. Typically, such awards are handled through a trust structure. Such rewards are usually contingent on ongoing employment over a duration of time, and they may also be linked to performance criteria.

4. Restricted Stock Unit:

In a restricted stock unit, an employee is typically given an opportunity to obtain shares at a future time, subject to certain requirements being met. The criteria of such a plan, like those of other types of ESOPs, include ongoing employment over a specified number of years and may also be subject to performance parameters. But unlike a restricted stock award plan, the personnel is not deemed a shareholder until the shares are actually granted to him or her, and he or she usually has no voting rights or dividend rights.

5. Phantom Equity Plan / Stock Appreciation Rights:

Employees are given notional units or shares at a pre-determined price in a plan that is styled after a phantom equity plan or a stock appreciation rights plan. The striking price is not paid, but it is listed as such on the grant date. The employee is awarded the cash value of the net benefit, if any, upon satisfaction of vested terms.

CONCLUSION

Employee stock options are a good way to improve human resources. India's competitive power is drawn from its people's abilities and talent. Here's where employee stock option plans (ESOPs) play a significant role in Indian Companies' success in global markets. Overall, India can go forward with ESOSs as it can provide the level of employee engagement and dedication needed to push the Indian economy into the new millennium.

Without a doubt, employee stock ownership plans (ESOPs) are a popular way for businesses to attract, inspire, and retain employees. ESOPs have a two-fold benefit: they reduce cash outflow while also keeping deserving staff for future growth. Employees also regard this plan as a long-term investment for which they must make up with monetary benefits and bonuses. If executed properly, ESOPs are favorable to both employees and companies.

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