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UNDERSTANDING ESOPS

- POLICY DESIGN
- TAX IMPLICATION
- TRUST STRUCTURE

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S N & Co.
CHARTERED ACCOUNTANTS

AGENDA

Basics of Share based payments in –

a. **ESOPs**
b. **Sweat Equity**
c. **CSOPs - Community Stock Options Pool**
d. **Phantom Shares**
e. **Stock appreciation Rights**

- **Planning ESOPS**
- **ESOP Policy**
- **ESOPS Backfire & Safeguards**
- **Issuing ESOPs through Trust**
- **Legal Compliances**

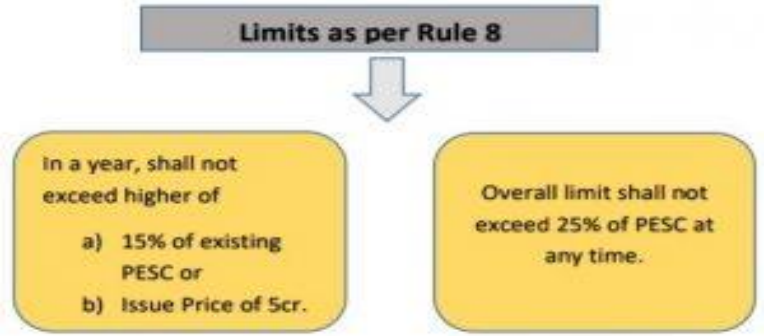
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ESOP V/S SWEAT EQUITY

Features	ESOP	SWEAT EQUITY
Eligibility	❖ All permanent Employees and Directors whether in India or Outside of Subsidiary and Holding ❖ Following are Not Eligible :- 1. Independent Director 2. Any employee belongs to Promoter group 3. Any Director holding directly or indirectly holding more than 10% (Not Applicable to eligible start-ups up to 5 years from incorporation)	All permanent Employees and Directors whether in India or Outside of Subsidiary and Holding who are into business for more than 1 year
Lock-in-period	As per Plan/Scheme	3 years as per Company's Rules

ESOP V/S SWEAT EQUITY

Features	ESOP	SWEAT EQUITY
Valuation	1. Grant of options- Registered Valuer 2. Exercise of options- a) Listed Co.: FMV of RSE b) Unlisted Co.: Merchant Banker	1. Valuation of IPR: • Listed Co. : Merchant Banker • Unlisted Co. : Registered Valuer 2. Valuation of share issued : • Listed Co.: FMV of RSE • Unlisted Co.: Registered Valuer
Restrictions	As mentioned in eligibility	As per Companies Rules:  This clause is not applicable to eligible startups. These Start-ups can issue sweat equity upto 50%
Taxation	At exercise of option : Difference of Exercise price and FMV of shares taxed as Salary (Explained in detail in the later part)	At Allotment of Shares : Taxed as Salary

COMMUNITY STOCK OPTIONS POOL

Advantages

- ✓ Efficient standard agreement
- ✓ Access to Growth Stage Startups
- ✓ Financial Protection
- ✓ Direct Investment
- ✓ Information rights

Disadvantages

- ✓ No entry on the Cap Table
- ✓ Mandatory Call Option
- ✓ No Voting rights
- ✓ No GST Credit

FEATURES	SHARE PAYMENTS		NON-SHARE PAYMENTS		
	ESOP	SWEAT EQUITY	SAR	PHANTOM SHARES	CSOP
On Allotment	Conditional allotment	Direct Allotment	No equity dilution	No equity dilution	What happens at initial stage of allotment
On Exercise	Option get converted to equity share on future date	Shares issued to employees at discounted price	Compensation given to employees for appreciation of company share price over a period of time	It is form of SAR	Are shares issued here ?
Cash-Flow	No cash outflow at all	Share can be sold by employees after completion of lock in period.	Mostly Issued by listed company since FMV is readily available	No initial cash outflow as shared from wealth created	Whether there is any cash outflow for subscribers ?
Issued to Whom?	To employees and directors to retain them	To acquire IPR from Employee and Directors	Can be used to pay employees	Can be used to pay vendors and consultants	Used at which level and how ?
Impct on Financials ?	Impact to P&L during vesting period : Grant value – exercise value	Impact to P&L in the year of allotment. : FMV value	Impact to P&L each reporting year until liability is Discharged	Impact to P&L each reporting year until liability is Discharged	What can be the impact on financials ?
Taxation ?	Tax on Exercise	Taxed on Allotment	Taxed on receipt	Taxed on receipt	How will it be taxed in the hands of subcriber and the Company ?
Valuation ?	FMV – Exercise price	Taxed on FMV	Taxed on differential value	Taxed on differential value – business income	What will be the valuation at redemption ?

HOW ARE ESOPS PLANNED?

A company is planning to introduce ESOP in their co.
Where, vesting is through Performance based conditions for the upper management (KRA & KPI)
For Marketing Manager, the vesting conditions are:

New Cities	Year	Options
15	1	200
20	2	300
25	3	500

Wherein the additional conditional is to earn minimum Revenue of Rs.1 Cr per city annually

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HOW ARE ESOPS PLANNED?

Performance based conditions for the upper management (KRA & KPI)

For Operations Manager(role of Bookings), the vesting conditions are:

Tickets booked	Year	Options
10L	1	200
15L	2	300
20L	3	500

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HOW ARE ESOPS PLANNED?

Tenure based conditions for the middle management:

For Managers, wherein FMV = 100 based on minimum 3 years with exercise price = 20

Vesting	Options
1	75
2	100
3	125

Lock-in period = 2 years

After the 3rd year, employees can exercise for selling.

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DRAFTING AN EFFECTIVE ESOP POLICY

- **Eligibility**

✓ Tenure-Based: Employees who have completed more than 12 months in the company.
✓ Performance-Based: (KRA) or (KPI).

- **Grant and Acceptance**

✓ Formal offering of ESOPs to eligible employees.
✓ Employees must accept the grant to participate.

- **Vesting Schedule/Conditions**

✓ Tenure-Based: Vesting is linked to the employee's duration of service.
✓ Performance-Based: Vesting depends on meeting specific performance targets.

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DRAFTING AN EFFECTIVE ESOP POLICY

- **Exercise**

✓ Exercise Price: Determined using the Black-Scholes Valuation Model.

✓ Exercise Period: Employees have a 5-year window to exercise their options.

- **Lock-in Period**

✓ A lock-in period of 5 years applies to the shares acquired through the ESOP.

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BACKFIRE & SAFEGUARD

Ways to retain the employees who desire to leave the company:

- **Reverse Vesting Clauses to Safeguard the Company:**

✓ Unvested Shares Forfeiture
✓ Partially Vested Shares Buyback
✓ Performance Clawbacks

- **Hybrid Vesting**
- **Second ESOP Grant Plan**
- **Profit Sharing (Cash Bonus)**
- **Leadership Perks**

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BACKFIRE & SAFEGUARD

Ways Safeguarding employees:

- **Define Clear Tiers:**

✓ Segment ESOP grants based on roles and contributions.(to rule out imbalance)

- **Performance-Linked ESOPs:**

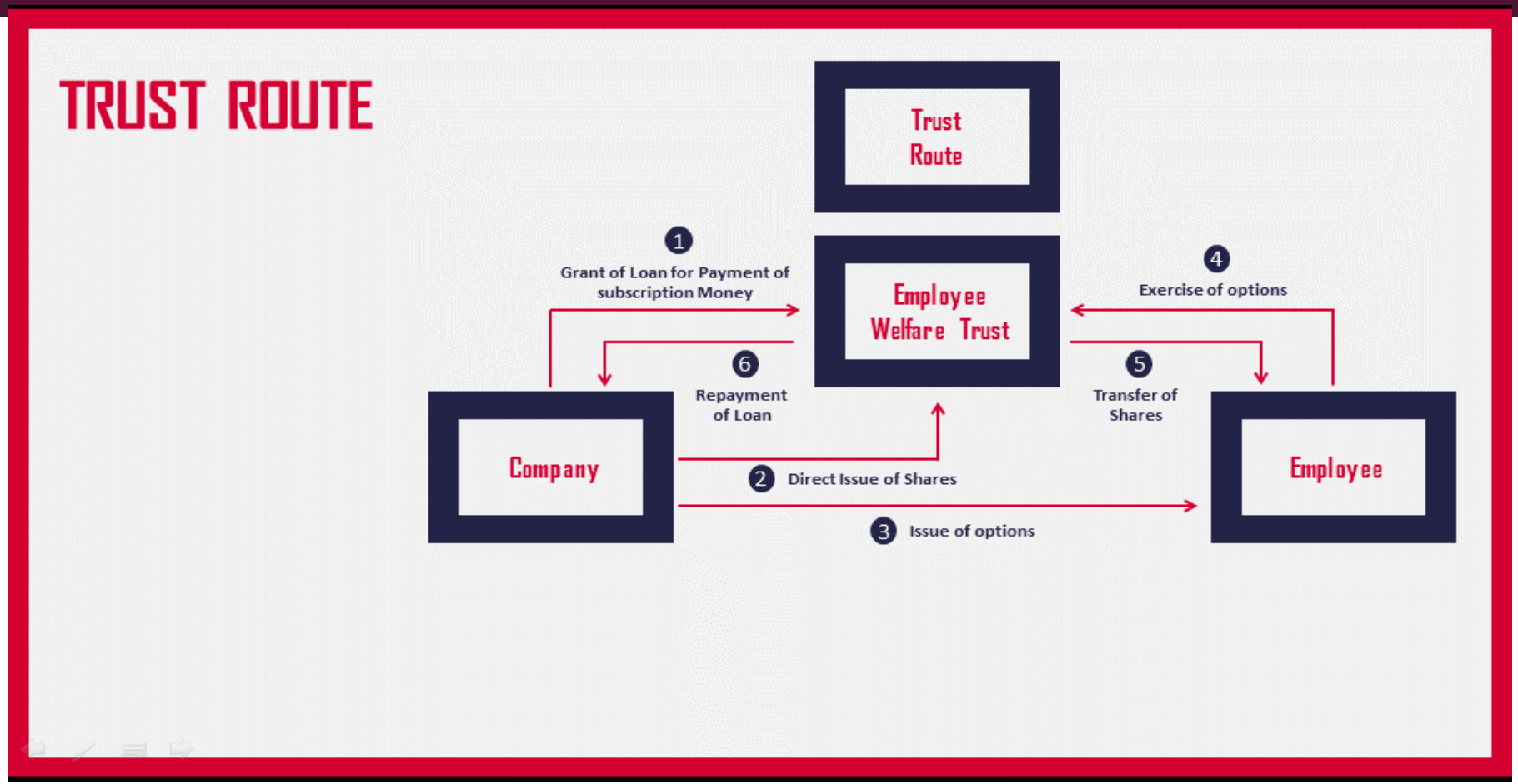
✓ Tie the vesting of ESOPs at all levels (CEO, senior managers, and others) to company-wide goals

- **Non-Equity Rewards for Balance:**

✓ Complement ESOPs with cash bonuses, profit-sharing, or promotions for non-ESOP employees to create a sense of fairness

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TRUST ROUTE OF ISSUING ESOP



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WHY PRIVATE LIMITED COMPANY CHOOSES ESOP TRUST ROUTE?

- **Simplified Approval Process:**

✓ Using an ESOP trust, the company avoids the need for separate approvals for every individual stock allotment.

✓ Once the ESOP scheme is approved by shareholders and regulators, the trust can manage allotments in line with the pre-approved framework, reducing administrative overhead.

- **Liquidity Management**

The ESOP trust can **buy back shares** from exiting employees. This ensures:

✓ Liquidity for employees when they leave the company.

✓ Retention of ownership within the company by preventing shares from being sold to external parties.

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LEGAL COMPLIANCES

- **ROC**

✓ **Board Approval**: The Board drafts the ESOP scheme and passes a resolution.

✓ **Remuneration Committee**: Approval of the scheme by the committee.

✓ **Shareholder Meeting**: Convene a meeting, approve the scheme, and pass a special resolution for trust creation.

✓ Submit Scheme to Income Tax Dept.

✓ **Employee Details**: Shareholder notice must include employee details and pricing.

✓ **Trust Setup**: Prepare and register a Trust Deed under the Indian Trusts Act with Registrar

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LEGAL COMPLIANCES

- **ROC**

✓ **PAN and Bank Account**: Obtain PAN and open a bank account for the trust.

✓ **Valuation**: Get a Registered Valuer's report for share valuation (for unlisted companies).

✓ **Loan to Trust**: Provide a loan to the trust to purchase shares.

✓ **Share Allotment**: Allot shares to the trust.

✓ **Transfer to Employees**: The trust transfers shares to employees at the Exercise Price.

✓ **Loan Repayment**: Trust repays the loan to the company using proceeds from employees.

LEGAL COMPLIANCES

Trust

- ✓ ESOP Trust registration is done under Indian Trusts Act , hence company need to prepare A Trust Deed. This need to be executed on stamp paper.
- ✓ A Trust Deed is to be registered in a sub-registrar.

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LEGAL COMPLIANCES

- **Taxation FAQs**

✓ Tax Deductibility of ESOP Expenses

✓ Taxation at the Time of Exercise(TDS)

✓ Taxation under Trust Route

LEGAL COMPLIANCES

- ## VALUATION OF ESOPS

1. Grant of options- Registered Valuer
2. Exercise of options-
   a) Listed Co.: FMV of RSE
   b) Unlisted Co.: Merchant Banker

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