


UNFOLDING ESOP VALUATION AND TAXATION ASPECTS




Overview of Concept ESOPs (Employee Stock Benefit Schemes)

Employee Stock Benefit Schemes/Equity Incentive Plans (commonly referred to as ESOPs) give the employees an **ownership interest** by participating in the Stock /Shares of the Company.



“Options/Units” is a **right** given to an Employee to purchase a given number of Shares of the Company at a future date, at a fixed pre- determined price.



“1 Option/Unit = 1 Equity Shares of the Company”



Objectives of Employee Benefit Schemes?



To **motivate** the employees to contribute to the growth and profitability of the Company.



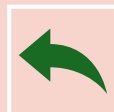
To **retain** the key employees and reduce the attrition rate of the Company.



To **achieve sustained growth** and the **creation of shareholder value** by aligning the interests of the employees with the long-term interests of the Company.



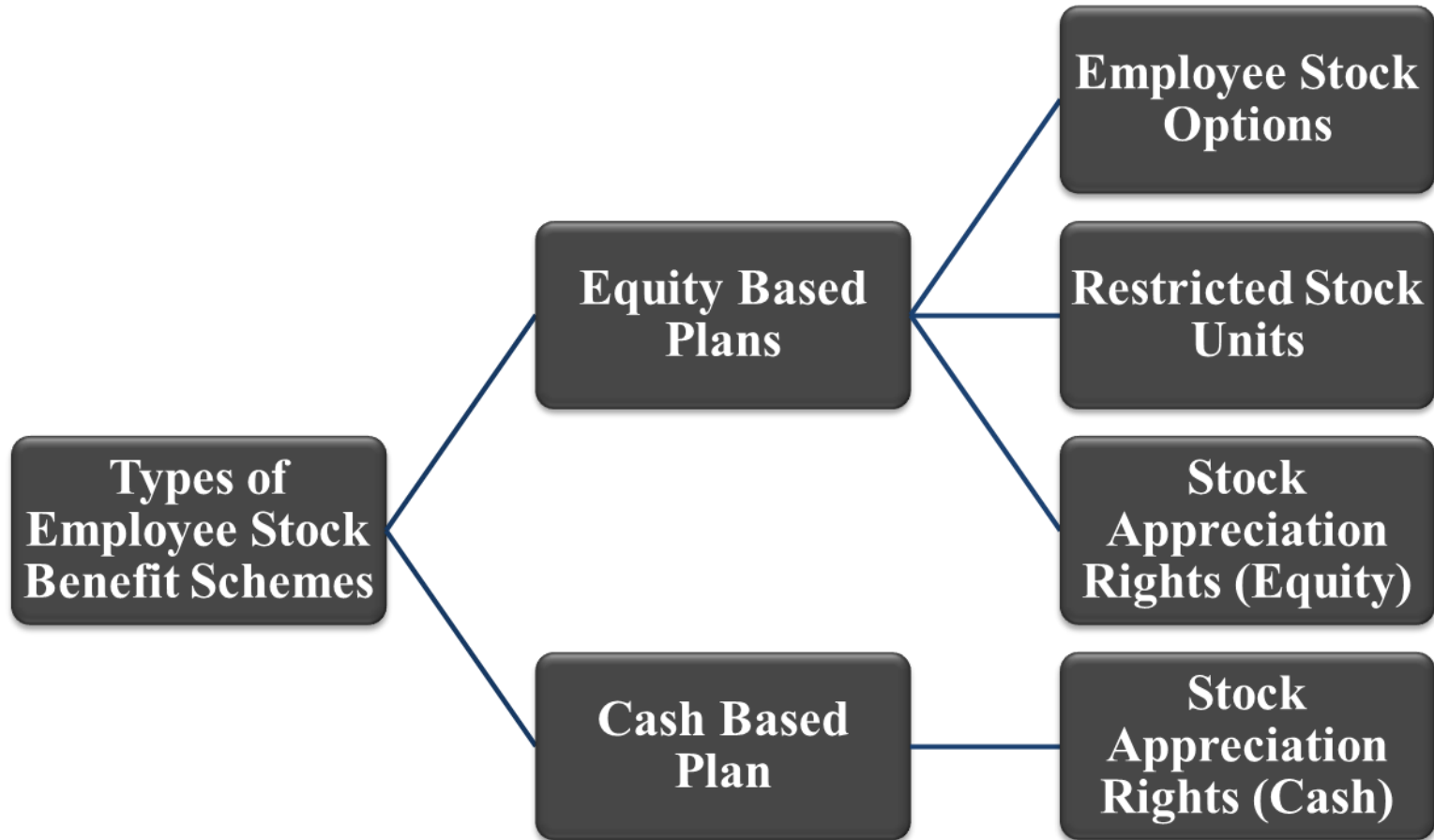
To **create a sense of ownership** and participation amongst the employees to share the value they create for the Company in the years to come, and



To provide **additional deferred rewards** to employees.



Types of Employee Benefit Scheme



Lifecycle of ESOPs

Create- ESOP
Policy

> An ESOP Policy stating the terms and conditions is formulated by the Company.

Grant-Issue of
Options

> “**Grant**” is the process by which the Company issues Options to the Employee.

Vest-Right
Earned

> “**Vesting**” is the process by which the employee receives the benefit of a Grant .

Exercise-
Convert into
Shares

> “**Exercise**” means the employee makes application for converting his option into Equity Shares.

Allotment:
Issue of
Shares

> “**Allotment**” is the process of issuing of Equity Shares by the Company to the Employee

Sale of Shares

> “**Sale of Shares**” means selling of the shares by the Employee after allotment.





Overview of ESOP Valuation

What is meant by the term “ESOP Valuation”?

Means the process to determine the **“Fair market value of Shares attached to an Option”** so offered to an employee under an ESOP Plan.

Under ESOP Valuation, the **Value of Shares** of the Company and **Value of Options** so offered to an Employee is determined by a Valuer.



Why ESOP Valuation?

At the time of Grant

Value determination: To determine Fair Market value of Shares to be offered to an Employee under an ESOP Plan.

Exercise Price: To establish the exercise price and understand tax implication in the hands of the employee and employer.

ESOP Cost Booking: Valuation is required to determine the ESOP Cost to the Company and for booking the same in the books of accounts.

EXERCISE
Exercises the right

VEST
Earns the right

GRANT
Receives the right

Vesting Period



Why ESOP Valuation?

At the time of
Grant

- ✓ **Who can conduct ESOP Valuation:**
 - Registered Valuers
 - SEBI Registered Merchant Bankers



Why ESOP Valuation?

Unlisted Entity

At the time of
Exercise of options

- **Perquisite Value determination:** Required in case of **unlisted Company** to determine **Fair Market value** of Shares of the Company at the **time of Exercise** to calculate the **perquisite value** in the hands of Employee.



Why ESOP Valuation?

Unlisted Entity

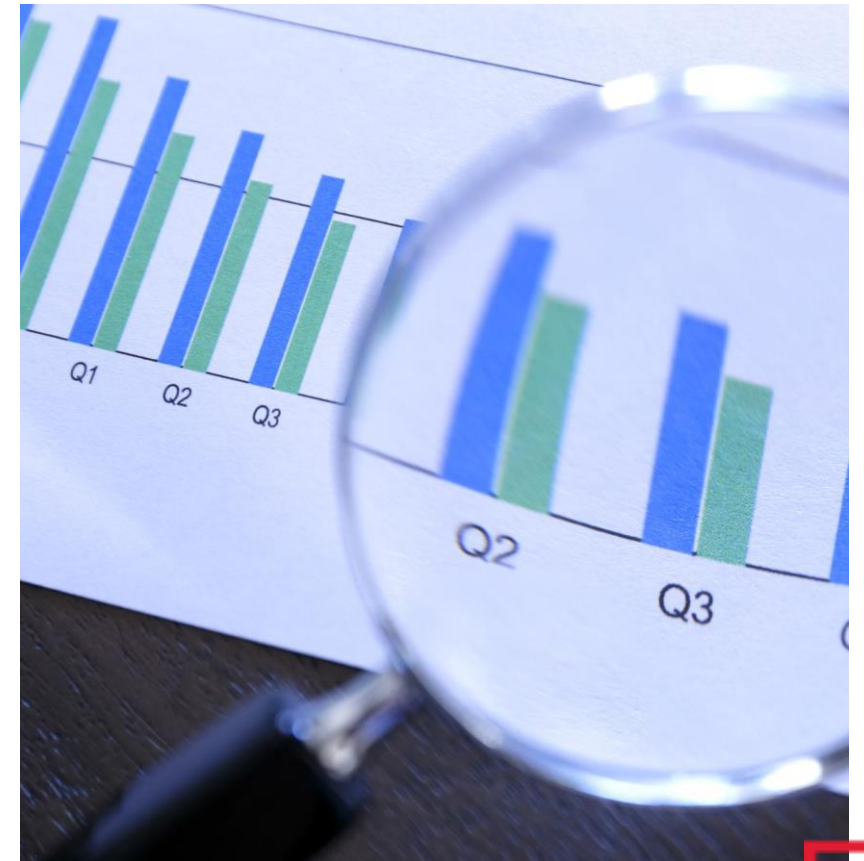
At the time of
Exercise of options

- ✓ **Who can conduct ESOP Valuation:**
 - SEBI Registered Merchant Bankers



ESOP Cost Accounting and Booking Period

- **Valuation Requirement under Ind AS 102- Share Based Payments :**
- **Ind AS 102** - Share-based Payment specifies the financial reporting by an entity when it undertakes a share-based payment transaction.
- In particular, it requires an entity to reflect in **its profit or loss and financial position** the effects of share-based payment transactions.
- This applies to both **Equity-settled share-based payment** transactions as well as **Cash-settled share-based payment** transactions
- Point of Calculation is **Grant** and Period of Booking is **Over the vesting period.**



ESOP Cost Accounting and Booking Period

- **Determination of the ESOP Cost:**

“Black-Scholes Model for Fair Value of Options”

As on grant date, fair value must be calculated as per IND AS-102 using the Black Scholes Model which is one of the popular methods opted by the Listed Companies.



ESOP Cost Accounting and Booking Period- Income Tax provisions

- **Recognition of the ESOP Expense can be claimed as deduction under Section 37 (1) of ITA by a Company:**

Yes, ESOP expenses claimed by the assessee is an allowable expenditure under Section 37(1) of the Income Tax Act. However, the section specifically does not state about ESOP expenses being an allowable expense.

Based on the various judgements by the High court, the ESOP expenses claimed by the Company is an allowable expenditure under Section 37(1) of the Act.

Case Laws:

- **New Delhi vs Lemon Tree Hotel Ltd**
- **Biocon Limited, Bangalore vs Department of Income Tax**
- **HDFC Bank Ltd Vs DCIT (ITAT Mumbai)**



Regulatory Requirement for Valuation as per RBI Circular for “Banks”



Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function staff - **Banks**

- RBI vide circular dated vide Circular no. RBI/2019-20/89, dated 4th Nov 2019 , came up with new guidelines on executive compensation to be applicable for pay cycles with effect from April 01, 2020.

Parameters	Guidelines
Applicability	<ul style="list-style-type: none"> • Mandatory for WTD/ CEO/ MRT/Control Function Staff in Private Sector Banks • Additionally, cover Local Area Banks, Small Finance Banks and Payment Banks , and foreign Banks operating in India.
Composition of Variable Pay	Cash, share-linked instruments, or both but including ESOPs
Period of deferral	<ul style="list-style-type: none"> • Minimum 3 years with equal or back-ended vesting • 1st vesting after 1 year • Vesting on yearly basis
ESOPs	<ul style="list-style-type: none"> • ESOP an integral part of Variable Pay. • ESOP quantum is specified as non-cash Variable Pay. • Requires specific mention in Compensation Policy of Bank
Valuation	Share-linked Instruments should be fair valued on the date of Grant of the Bank using the Black Scholes Model.
Accounting	The fair value thus arrived at should be recognised as expense beginning with the accounting period for which approval has been granted”.



Point of Taxation in ESOPs for Employee

Point of Taxation in ESOP's:

The Income-tax Act, 1961 imposes taxation on Employee Stock Options (ESOPs) in the **hands of Employees.**

- **Double point** of taxation in the hands of employees in case of **Equity Settled Share based payments**

At the time of Exercise of Options-
Perquisite Tax

At the time of Sale of Shares-
Capital Gain Tax



Point of Taxation in ESOP's:

- Single point of taxation in the hands of employees in case of **Cash Settled payments**

At the time of Exercise of Options-
Perquisite Tax



Point of Taxation- ESOP **Perquisite** Calculation for Employees

At the time of
Exercise of
options

Requirement and Chargeability under Income Tax Act 1961:

“Section 17 A read with Rules 3 of the ITA.”

“Salary Income” -Section 17(2)(iv) defines the term “perquisite” which includes

“ 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:

- *Under the said section, the term specified security includes “Options” issued to an employee under an ESOP Plan.*
- *Further , the value of any specified security shall be the fair market value of the specified security as the case may be, on the date on which the “Option is exercised” by the Employee.*
- *The value of the perquisite is determined as per Rule 3(8) of the Income Tax Rules. .*



Point of Taxation- ESOP **Perquisite** Calculation for Employees

At the time of
Exercise of
options

Rule 3(8) of the Income Tax Rules- “Valuation of perquisite”

The said rule provides “**determination of fair market value**” of the specified security on the date when the option is exercised by the employee.

(i) In a case where, on the date of the exercising of the option, the share in the company is listed on a recognized stock exchange:

the fair market value shall be the average of the opening price and closing price of the share on that date on the said stock exchange.

(ii) In a case where, on the date of exercising of the option, the share in the company is not listed on a recognised stock exchange,

the fair market value shall be such value of the share in the company as determined by a merchant banker on the specified date.



Point of Taxation- ESOP **Perquisite** Calculation for Employees

At the time of
Exercise of
options

Determination of Perquisite value:

- **Perquisite Value** is difference between the *Fair Market Value of the Shares as on date of Exercise and the Exercise Price.*



Point of Taxation- ESOP **Perquisite** Calculation for Employees

At the time of
Exercise of
options

Taxability in the hands of employees:

- **The perquisite Value** so determined shall form the part of the salary of the employee in the month of Exercise.
- The employee will be **liable to pay the taxes on the perquisite value** as per the individual slab rate in which he falls.

E.g.: Exercise Price = Rs. 10 per Option / Market Price of share on exercise = Rs. 30 per shares / Perquisite = Rs.30 – Rs.10 = Rs.20/- per share.

Suppose employee falls in 30% slab, his perquisite tax will be Rs.6/-



Point of Taxation- **Capital Gain** Calculation for Employees

At the time of
Sale of Shares

What is Capital Gain:

Difference between the **Sale Price** and **Fair Market Value as on date of Exercise of option** is taxed as capital gains in the hands of employee.



Point of Taxation- **Capital Gain** Calculation for Employees

At the time of
Sale of Shares

The Employee may choose to sell the shares once the Shares are allotted and credited in his demat account. As the employee sells these shares, another tax event happens.

Accordingly, taxes shall be paid by the employee based on the period of holding either as:

- **Short Term Capital Gain**
- **Long Term Capital Gain**



Point of Taxation- **Capital Gain** Calculation for Employees (**Unlisted Shares**)

A. Short Term Capital Gain u/s 45 of the Income Tax Act, 1961- If the period of holding is not more than 24 months, then the gain shall be short term Capital Gain.

Period of Holding = Less than 24 Months
Rate of Tax= As per Individual Slab Rates

B. Long Term Capital Gain u/s 112 of the Income Tax Act, 1961- If the period of holding is more than 24 months, then the gain shall be long term Capital Gain.

Period of Holding = More than 24 Months
Rate of Tax =20% (if indexation benefit taken);
10% (if no indexation benefit is taken)



Point of Taxation- **Capital Gain** Calculation for Employees (**Listed Shares**)

- A. Short Term Capital Gain u/s 45 of the Income Tax Act, 1961-** If the period of holding is not more than 12 months, then the gain shall be short term Capital Gain.

Period of Holding = Less than 12 months

Rate of Tax= 15%

- B. Long Term Capital Gain u/s 112 of the Income Tax Act, 1961-** If the period of holding is more than 12 months, then the gain shall be long term Capital Gain.

Period of Holding= Less than 12 months

Rate of Tax = Till 1 lakh – exempt

Over above 1 lakh- 10 % (without indexation benefit)



Start-ups Recognition and Tax exemption



DPIIT Start-ups Recognition and Tax exemption:

Eligibility Criteria for Startup Recognition:

- Turnover less than INR 100 Crores in any previous financial year.
- Considered a startup up to 10 years from incorporation.
- Focused on innovation/improvement of products, services, and processes with potential for employment generation/wealth creation.
- Not formed by splitting up or reconstructing an existing business.



DPIIT Start-ups Recognition and Tax exemption:

Deferment of **Perquisite Tax** for employees on Employee Stock Options (ESOPs):

Budget 2020: The government has deferred the TDS or perquisite tax payment on Shares allotted by the start-ups to their employees under ESOP Plans.

The **perquisite tax** amount has only deferred which means the said amount has to be paid by the employee at the later stage.

- **Eligibility:** Startups recognized by DPIIT.
- **Objective:** To attract and retain talent by offering employee stock options without immediate tax liability
- **Benefit:** Deferment of **perquisite tax** payment on ESOPs by employees for a period of five years, or until they leave the company, or when they sell their shares, whichever is earliest.



Taxation in case of Foreign Employees:

Pursuant to the applicable Provisions of Income Tax Act, 1961, the following are the tax implications in the hands of Employee who is a resident outside India:

Consideration for Non-Resident Employee: At the time of Exercise – “Perquisite Value”

If the Services are rendered or accrued in India-

Perquisite in relation of the services rendered in India **shall be taxable in India.**

If the Services are rendered outside India-

Perquisite in relation of the services **shall not be taxable in India.**



Taxation in case of Foreign Employees:

Consideration for Non-Resident Employee: At the time of Sale of Shares – “Capital Gain”

- The sale of shares of an Indian company shall be deemed to be Income Accruing and arising in India and shall be *taxable in India irrespective of the tax residence status* of the transferor of the shares and the tax amount to be paid will be withheld at the time of transfer through Demat account.
- However, the employee can claim **relief in accordance with the Double Taxation Avoidance Agreement (DTAA)** of his country of residence with India.

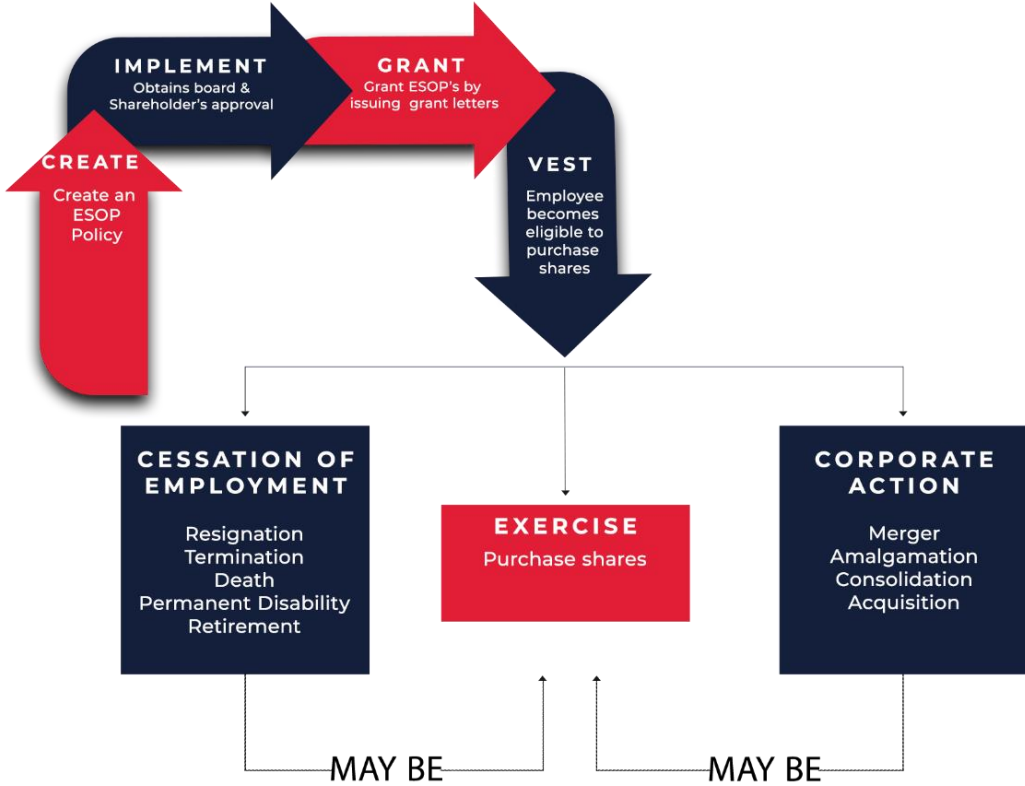


ESOP Valuation

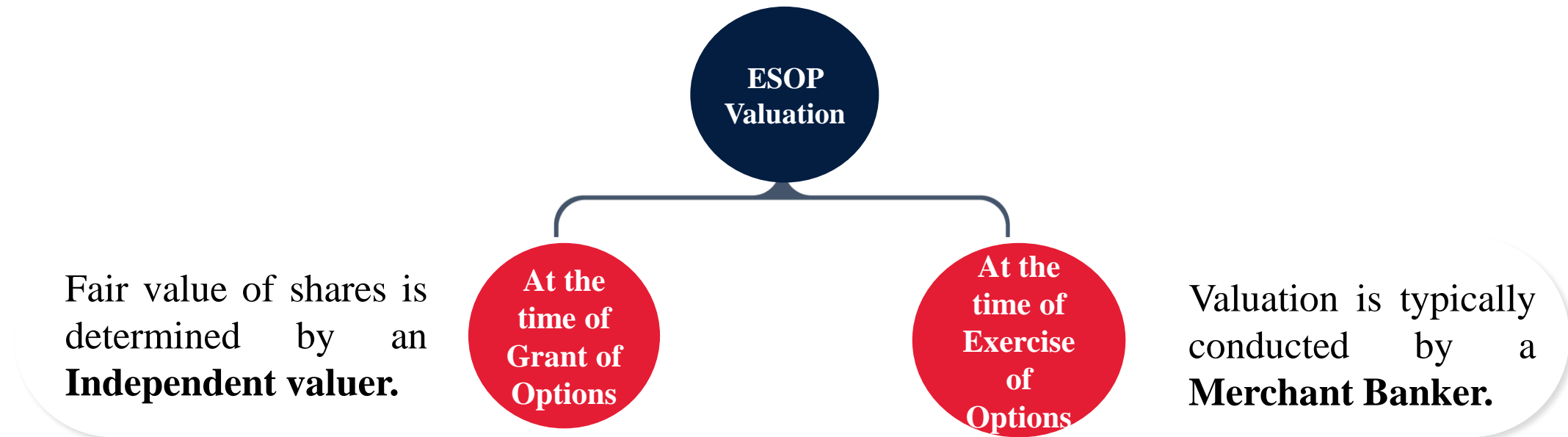


Life Cycle of ESOP Option

Life Cycle of ESOP



What is ESOP Valuation?



WHO NEEDS ESOP VALUATION AND WHY?

Companies require ESOP value for both:

Phase I: Accounting reasons: During the vesting period, the company issuing the ESOPs is required to record the compensation expenses.

Phase II: Tax reasons: ESOP values aid in calculating the perquisite tax that employees of the corporation must pay

.



When is ESOP Valuation required?

STAGES OF ESOP



Trigger



ESOP Option valuation is required by an Independent Valuer.

ESOP Tax Perquisite valuation is required by a Merchant Banker.

Who does it?



Independent Valuer

Merchant Banker



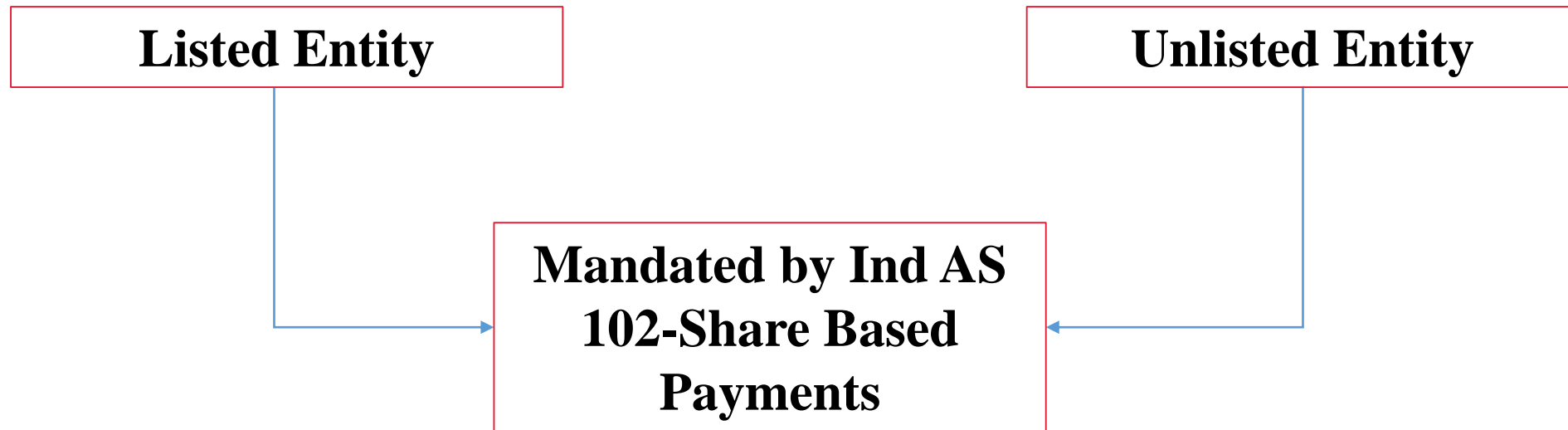
Phase I: Accounting Reasons



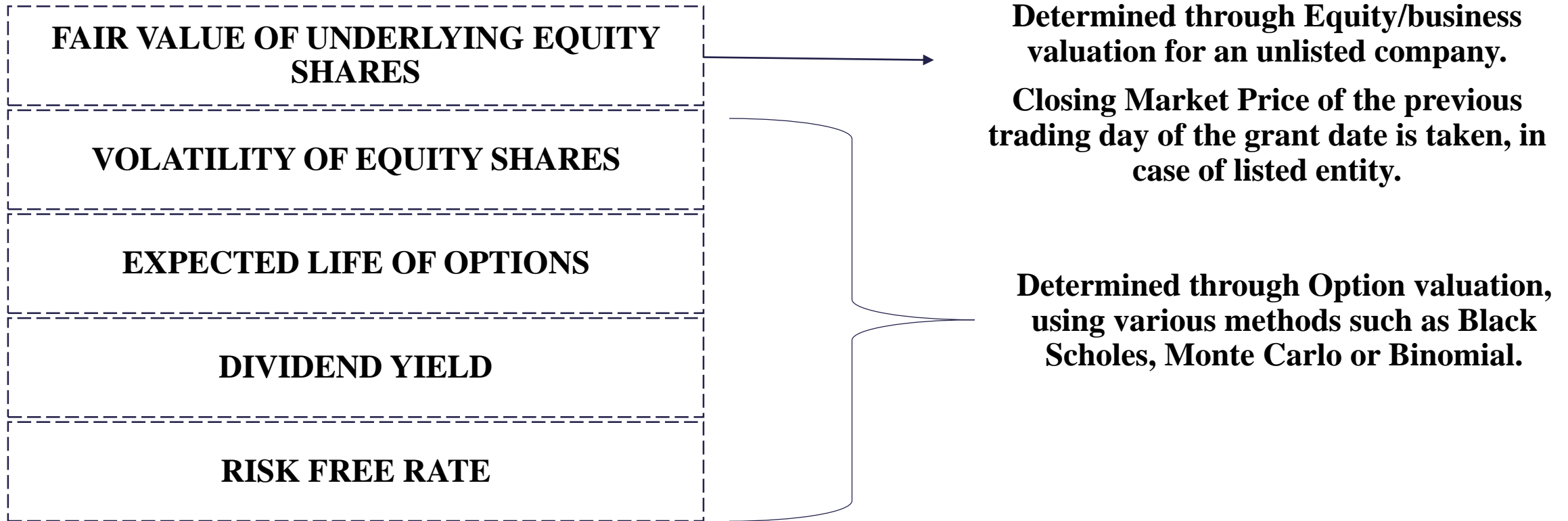
Valuation for Accounting Purposes at the time Grant

The company calculates how much it will spend to give employees shares through ESOPs, considering factors like the number of shares and their value.

At time of Grant of Options, valuation certificate from an Independent valuer before end of Financial Year is required by both:



Key Elements for Valuation for Accounting Purposes



Recommended Methods for Valuation

Black-Scholes: Developed by economists Fischer Black, Myron Scholes, and Robert Merton, the Black-Scholes pricing model is the most renowned and widely recognized option pricing model.

Key assumptions of the model:

- The model is designed for European-style options, which means these options can only be exercised at the expiration date.
- The model assumes that stock prices exhibit the log-normal property, implying that the percentage changes in stock prices are normally distributed. This assumption plays a fundamental role in the model's calculations.
- In its original form, the Black-Scholes model did not factor in equity dividends. However, subsequent refinements to the model have been made to incorporate the impact of dividends on option pricing.



Recommended Methods for Valuation

Binomial: More flexible than Black-Scholes-Merton.

Key assumptions of the model:

- The model is specifically designed for American-style options, which can be exercised at any time leading up to the option's expiration date.
- It assumes that stock prices follow a binomial distribution. This means that, over discrete time intervals, the stock price can move in two possible directions, either up or down.
- At each time step, the stock price can move in two directions, leading to two different possible outcomes.
- The model involves creating a tree-like structure with multiple nodes, each representing a specific time interval. This tree helps visualize the potential stock price movements over time.
- At each node, the model calculates the expected share price and the expected option value. This calculation process continues throughout the tree until reaching the final nodes, ultimately providing the option's estimated value.



Phase II: Tax reasons



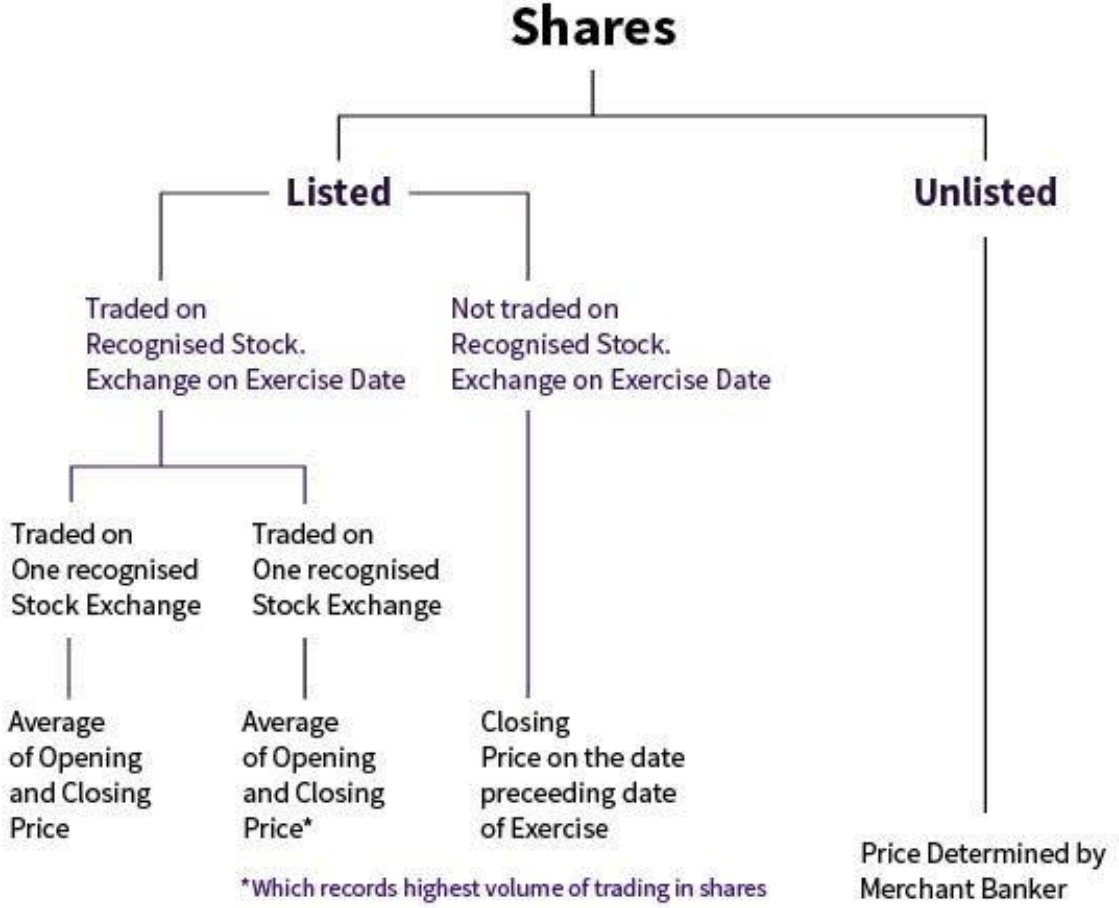
Valuation of ESOP for Tax Purposes

The Income-tax Act, 1961 provides for taxation of ESOPs as a perquisite at the *time of exercise*, subject to the valuation of the perquisite as prescribed in the Income-tax Rules, 1962.

An unlisted company must obtain a valuation certificate from a Category 1 Merchant Banker registered with SEBI as of a *date not earlier than 180 days prior to date of exercise*.



FMV of Shares at the time of Exercise



Amendments introduced vide Budget 2020 for Startups

Beginning from the fiscal year 2020-21, tax is not payable when employees exercise their ESOP options.

However, the **Tax Deducted at Source (TDS)** on the "perquisite" of ESOPs is payable until one of the following events occurs:

- **5 years from the ESOP allotment date.**
- **The date when the employee sells their ESOP shares.**
- **The date of employment termination.**



Eligibility Criteria for Startup Recognition

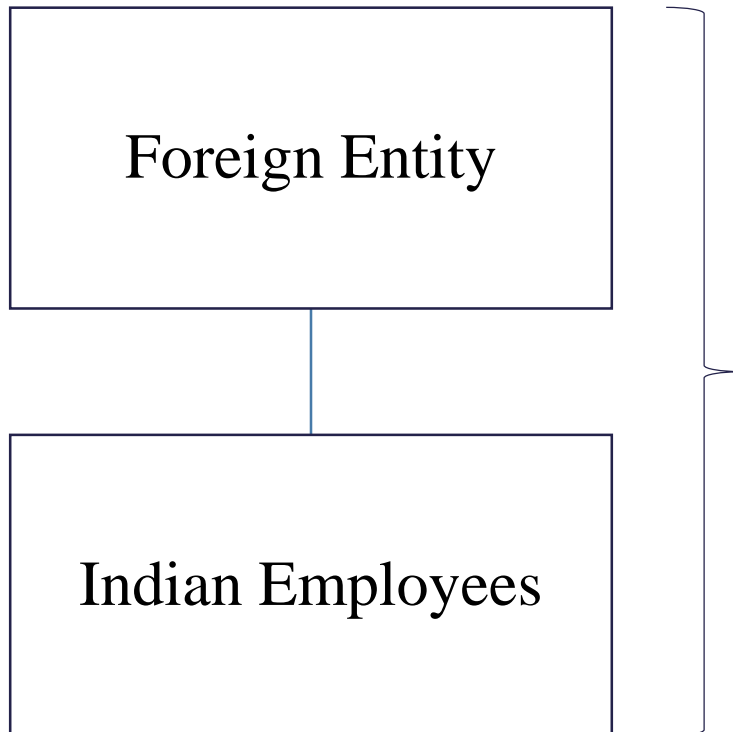
- The Startup should be incorporated as a private limited company or registered as a partnership firm or a limited liability partnership
- Turnover should be less than INR 100 Crores in any of the previous financial years
- An entity shall be considered as a startup up to 10 years from the date of its incorporation
- The Startup should be working towards innovation/ improvement of existing products, services and processes and should have the potential to generate employment/ create wealth.
- An entity formed by splitting up or reconstruction of an existing business shall not be considered a "Startup"



ESOP Valuation for Foreign Entities under Income Tax Act



International corporations give Indian employees incentives



At the time of exercise of foreign options Income tax 1961 provisions are applicable for the purpose of Tax perquisite.



International corporations give Indian employees incentives

If a foreign company gives ESOP to its Indian employees, they need to evaluate the perquisite value for tax purposes as required under the provisions of the Indian Income Tax Act, 1961.



FMV of Shares on date of Exercise

409A Valuation is required for firms based out of USA to determine the FMV of shares by a Merchant Banker as per Income tax Act 1961.

Public companies are valued by the price their stock trades at in the market, but private companies need a valuation to determine the fair market value (FMV) of their equity. A 409A valuation also establishes the “strike price” (the price at which equity can be bought) that must be at or above FMV

It is also a proof that a company calculated a reasonable fair market value of its common stock. This will help ensure that the valuation will be accepted as valid by the IRS.

For foreign entities not based in the USA, international valuation standards apply for determining the fair market value (FMV) of foreign options at the time of exercise.



When and how frequently do you need a 409A valuation?

When do you need a 409A Valuation?



Before issuing initial
common stock options



Once every 12 months



Upon any material event



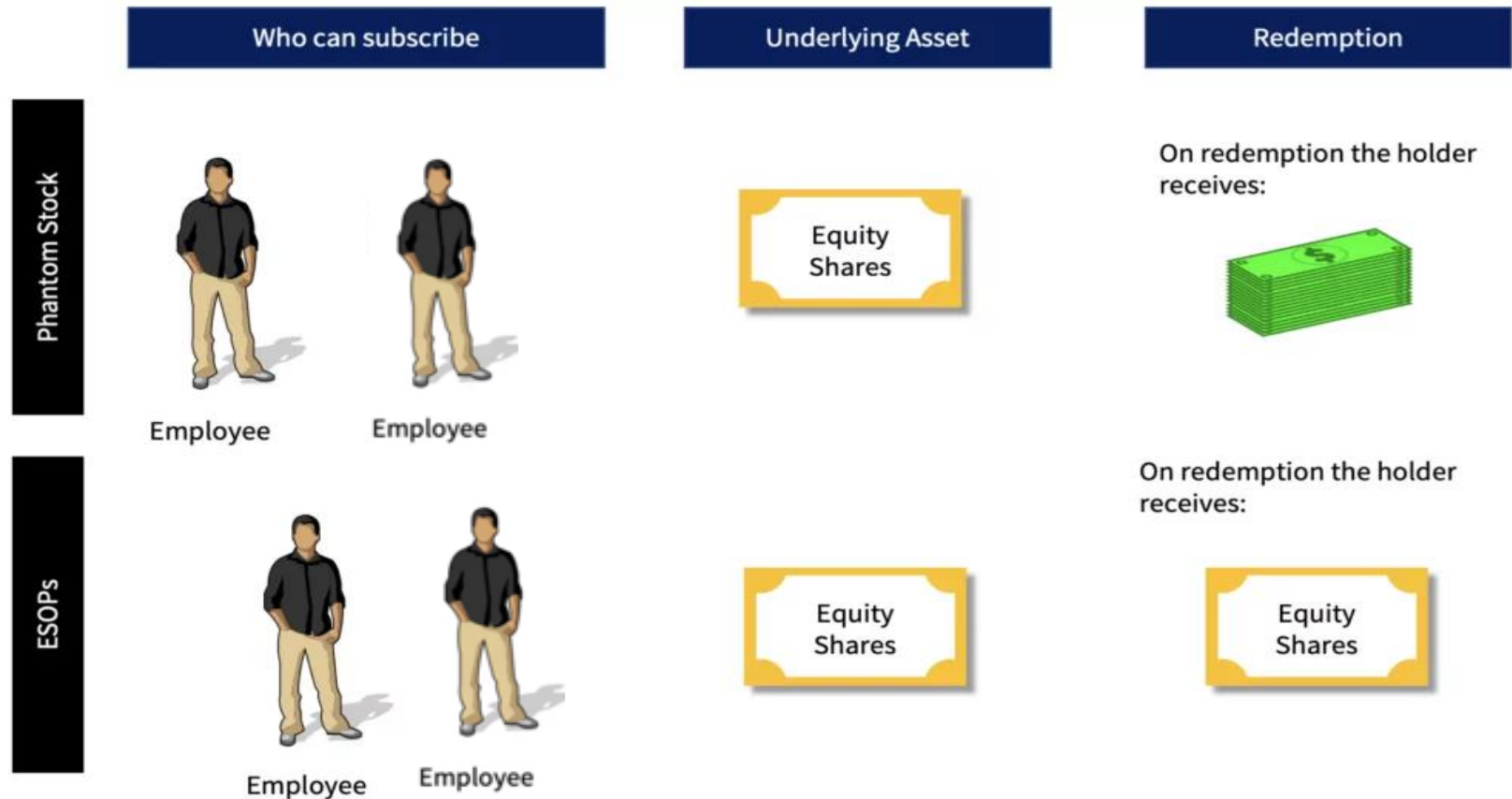
When and how frequently do you need a 409A valuation?

- A 409A valuation is first required before **granting any employee stock option grants**, establishing a fair and transparent foundation for aligning employee incentives with the company's actual market value.
- While these valuations typically remain **valid for 12 months**, regular updates are crucial, especially for subsequent option grants.
- Even beyond mandatory situations, it is a best practice to conduct 409A valuations every tax year to maintain compliance and ensure continued accuracy.
- Additionally, significant material events like major funding rounds, mergers, and acquisitions, liquidity events, or substantial shifts in the company's business can trigger the need for a new valuation, even if the previous one is still technically valid.



Phantom Stock Valuation

Phantom stock compensates employees by awarding shares that mimic actual stock value, providing cash or equivalent value upon vesting, aligning employee interests with company performance without granting ownership.



Phantom Stock Valuation

At the grant date, the fair value of phantom stocks is estimated based on the current stock price and any other relevant factors. This initial valuation sets the basis for recognizing the liability.

The fair value of phantom stocks must be updated at each reporting date. This involves revaluing the phantom stock based on the latest market price of the underlying shares and adjusting the liability accordingly.





Thank You!

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