

## **New guidelines on ESOPs would mean more Administrative effort**

ESOP Designer team of ESOP Direct

The Finance Act 2001 provides for significant changes in the definition of perquisites. The benefit to the employees from ESOP is however excluded from this definition if the ESOP scheme of the company is in compliance with the prescribed Central government guidelines. These guidelines have been recently announced.

If the scheme complies with these guidelines, the entire ESOP benefit will be taxed in the hands of the employees only at the time of sale of shares, else the tax incidence will be on two occasions, once on exercise of options (as a perquisite) and then at the time of sale of shares (as Capital gains). In this context these guidelines were very important both for the companies as well as employees.

### ESOP defined

The guidelines define the routes through which employees could acquire shares of the company. There are five such routes.

More importantly, the guidelines allow companies to implement a plan whereby the employee saves an amount from his monthly salary and gives it to company to acquire shares (normally) at a discounted price. Typically a similar Plan in the US would work like this: Employees contribute a % of salary every month for a defined period usually 24 months and get shares at the end of the period at a say 15 % discount to MP on the last day of the period or the first day of the period whichever is lower. Hence the company would either issue new shares/issue out of treasury stock or purchase from the market depending on how much the actual discount is to MP on the day it needs to issue to employees. This initiative will help in promoting 'employee ownership' culture in the country.

It would now be possible for companies to buy shares from the market in the ESOP trust and use them to issue Options to employees. It however needs to be seen whether for the company the discount to the market price (which would be funded by the company) would be allowed as a deductible expenditure. Most probably the answer is no because the employee is not being taxed correspondingly.

The Employee Stock Option Scheme (ESOS) is defined twice and with different meanings. This appears to be an oversight. Definitions of Employee Stock Ownership Plan (sub clause (ii) of clause 1) and Employee Stock Option Scheme (sub clause (iv) of clause 1) are same. If a different meaning is implied it needs to be clarified.

Stock Appreciation Rights are also specifically defined. Though this instrument is not yet popular in India, it is now available for companies who want to use it.

Another noticeable feature of the definitions is the specific mention of the trust route for issuing Options to employees. SEBI guidelines do not make a specific mention about the Trust route being used. This has created confusion whether schemes with trust route are in compliance with SEBI guidelines or not. This confusion will at least not be there for compliance with these guidelines.

## Written document

It is mandatory for the companies to frame the ESOP scheme in a written form and submit it to the Tax authorities. The contents of the written document should include details such as number of shares to be issued, class of employees entitled to participate, pricing formula including the price at which the shares are offered, lock in period for such shares, etc. In case of unlisted companies, the basis for valuation of shares is required to be mentioned. It is not clear as to why the Tax authorities would need the basis for valuation since there is no perquisite element in this transaction. There are other related issues such as who would do this valuation? Apparently there is no third party certification required. The guidelines also refer to the last three years' financial statements to be the base for this valuation. It is well known that there are many more dimensions to the value of a share than just last three years' financials.

The guidelines also provide that the written document (scheme) cannot be changed after the scheme comes into effect. This is a very restrictive clause because there could be valid reasons such as Re-pricing, Merger / amalgamation, Rights or a Bonus issue, IPO, etc. where the scheme would need a change. In many of these events the change could be as basic as the price, number of options granted, etc. One way to address is to cancel the scheme and introduce a new plan. Apart from this being a difficult and impractical solution, the guidelines do not provide for cancellation of the scheme. Another complication may also arise. If there were a change in the scheme for genuine reasons, would the benefit be then taxed as a perquisite? If so, then from which date? For which employees? We need to wait to see how tax authorities would address this issue. Moreover, a scheme would typically run for an year or more with multiple grants. It would be practically impossible to give data such as list of eligible employees, basis for award, valuation, pricing, etc. It is quite normal for the Compensation committee to change the basis, quantum and allocation for each grant based on circumstances.

## Applicability

The guidelines apply to almost all those employees who are likely to be taxed for their Salary income in India. Thus it covers Indian subsidiaries of foreign listed companies, Indian resident employees of a foreign company (with business in India), Indian companies listed only abroad (for instance companies like Rediff, Sify, etc). The holding and subsidiary companies are also covered.

## Compliance with other laws

It is also required that the scheme does not contravene with any other law in force. The relevant laws here are the Companies Act, FEMA, SEBI guidelines on ESOP and RBI guidelines on ESOP and issue of Indian securities to non-Indian employees and foreign securities to Indian employees. Apparently, compliance with SEBI guidelines is not mandatory for unlisted companies in view of the words "wherever applicable" used in clause 3. There are however some listed companies who have not complied with SEBI guidelines because they implemented ESOPs before the guidelines came into effect (19th June 1999). Such companies will now have to fall in line with these guidelines.

## Filing of the written document

The guidelines require the written document with all the necessary contents should be filed with the Chief Commissioner of Income Tax within six months of the issue of these guidelines or six months from the effective date of the scheme whichever is later.

Since the guidelines are effective from 1st April 2000, the written document for all the grants made after that date will have to be filed within six months of its publication in the gazette. It appears that the information to be filed with the Tax authorities does not cover crucial information such as which employees have exercised the options during a given period. This is a very pertinent data for the tax authorities, since only those employees who have exercised will have the tax incidence. Other's who have options but no shares will be of no use to them. Moreover the information will be filed with the Tax authorities at the time of grant, whereas the tax liability on the gains will arise over a period (typically 3-4 years). There's no point in the data lying with tax office for such a long time. It will make the tracking more difficult. Instead the data should reach tax office at a time closer to tax incidence, i.e. on exercise of options.

The compliance with these guidelines will mean some extra effort on the part of the companies. Initially to fall in line for the transactions after 1st April 2000 and then as and when new grants are made. The effort would be significantly higher for Indian subsidiaries of foreign companies who are currently not required to do any periodical filings with Tax authorities. They would also have difficulty in providing on going data on Valuations of parent company's shares, employee details, etc.

For more details contact us at: [EDinfo@esopdirect.com](mailto:EDinfo@esopdirect.com)