ESOP VISTAS

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CBDT's Draft Notification on exemption from long-term capital gains in respect of certain modes of acquisitions of shares of a listed Company

1. Background

1.1 Section 10(38) of the Income Tax Act, 1961 up till now has been one of the most attractive provisions for the investor community including employee stock option ("Option"/ "ESOP") holders of a listed Company in India. This Section seeks to exempt long-term capital gains ("LTCG") tax arising out of sale of listed equity shares ("Share") of a listed Company in India, undertaken after October 01, 2004 being chargeable to Securities Transaction Tax ("STT"). The most important criteria for claim of exemption used to be chargeability of STT at the time of sale of Shares. Chargeability of STT at the time of acquisition of such Shares was not relevant for claiming the exemption hitherto.

1.2 However, the Finance Act, 2017 sought to bring an altogether a new requirement by inserting a 3rd Proviso to the aforesaid Section with effect from April 01, 2017. This new Proviso mandates that all modes of acquisition of Shares on which STT is not chargeable at the time of acquisition shall not qualify for exemption, except those modes notified by the Central Government in this regard.

1.3 Accordingly, the Central Government came out with a draft Notification vide Press Release dated April 03, 2017 ("Draft Notification") seeking public comments on certain modes/transactions of acquisition of Shares specified therein as being not being chargeable to STT, but would still qualify for exemption under Section 10(38).

1.4 Even though, the said amendment is prompted by noble reasons e.g. as an anti-abuse measure, to avoid tax evasion, etc., there are yet chances of more genuine transactions of acquisition of Shares that may face the trouble if not properly specified in the relevant Notification. Some of such genuine transactions like acquisitions in IPO, FPO, Bonus/ Rights issue, etc. have been spelt by the Central Government itself in the Memorandum explaining the provisions of Finance Act and also in the Press Release stated above. However, there are yet other genuine transactions which need a very clear mention in the relevant Notification.

1.5 Given the background above, by way of this newsletter, we wish to share our understandings and few concerns as well in respect of the Draft Notification from an ESOP perspective. We have also submitted our comments and suggestions to the Finance Ministry on the draft Notification.

2. Our analysis and views

2.1 The Draft Notification specifies all transactions of acquisition (both subscription and purchase) of

Shares to qualify for exemption except three transactions ("Disqualifying Acquisitions") as under:
(i) Acquisition of infrequently traded Shares on a recognized stock exchange through a preferential issue other than an issue made on conversion of loan or debt instruments, pursuant to a scheme of restructuring approved by a High Court, and under a scheme of rehabilitation approved by Board of Industrial and Financial Reconstruction;
(ii) Purchase of shares not entered through stock exchange i.e. off-market acquisition; and
(iii) Acquisition of Shares during the period of delisting in case of a Company which is subsequently re-listed.

2.2 In an ESOP environment in case of a listed Company, the Shares underlying Options can be acquired by the grantee employee ("Grantee") either through Direct route or through Trust route upon exercise of Options as under:
A. Direct route: Company directly issues the (primary) Shares to the Grantees upon exercise which then are listed on a recognized stock exchange as per relevant SEBI Regulations. As it does not fall in any of the Disqualifying Acquisitions, the Grantee can continue to claim exemption as usual.
B. Trust route: Company sets-up a Trust with a view to park primary Shares or Trust acquires secondary Shares from market with a view to transfer such Shares to the Grantees upon exercise, as under:
(i) Trust using primary Shares: Here, there are two transactions. Firstly, Trust subscribes to the Shares of the Company. Secondly, the Trust makes an off-market transfer to the Grantee upon exercise of Options as per Regulation 3(14) of SEBI (Share Based Employee Benefits) Regulations, 2014 ("SEBI SBEB Regulations"). The Trust merely acts as a conduit and there is no change of character of Shares i.e. the primary-ness is intact up to acquisition by the Grantee. As this transaction cannot be routed through a stock exchange, this also does not fall in Disqualifying Acquisitions leading to usual exemption under Section 10(38).
(ii) Trust using secondary Shares: Where ESOP Scheme of a listed Company envisages use of secondary Shares, its Trust acquires Shares either (a) through a recognized stock exchange by paying STT, or (b) from promoters as a gift. Both these modes of acquisition of secondary Shares have been approved under SEBI SBEB Regulations. Irrespective of mode of acquisition by the Trust, the Grantee receives the Shares only through off-market transfer as a default mode and that too under a regulated ESOP policy where exercise price is constant. There is no choice available with the Grantee for choosing the mode of acquisition - on or off the market. Thus, in our view, point (ii) of the Disqualifying Acquisitions does not apply and exemption is intact. Moreover, in the former case, the Trust pays STT in respect of Shares acquired for and on behalf of the Grantees (also known as beneficiaries under Trust) which fact is well recognized by statutes and statutory authorities. Thus, as the Grantee is deemed to have paid the STT on acquisition of Shares, he/she would get exemption under Section 10(38) on sale.

2.3 The Draft Notification indicates that excepting the Disqualifying Acquisitions, all other acquisitions shall continue to get exemption as usual. It is welcome and desired too. However, for the sake of clarity and better compliance by stakeholders, we have represented before the Finance Ministry with a request to mention the modes of acquisition of Shares under the ESOP Plans more specifically.