ESOPs- The Mechanism of Employee Stock Option
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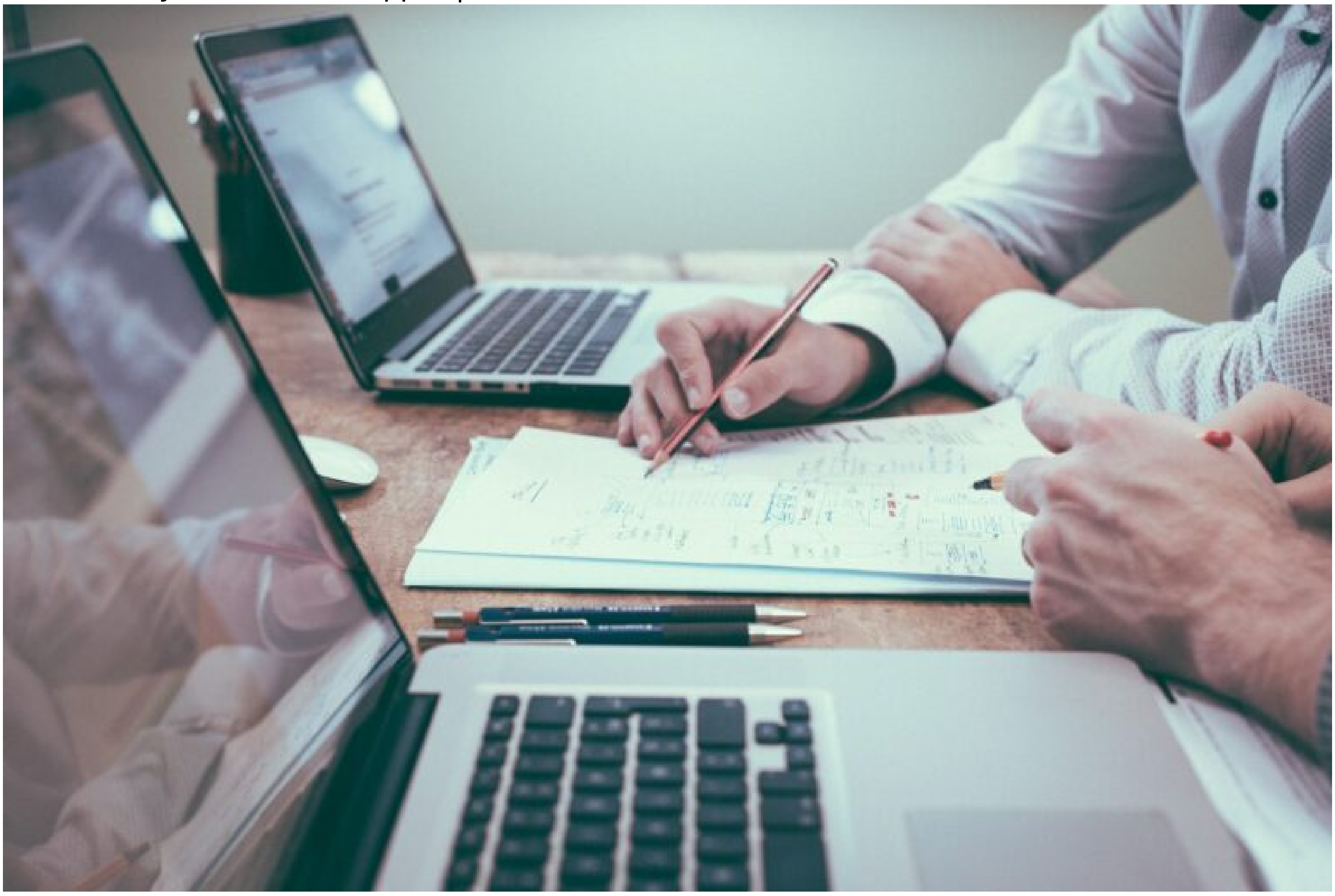
– *A continuous business protraction*
Employee stock option plans or Employee Stock Ownership Plan (ESOP) can be described as a type of equity remuneration that companies give to their employees and executives. The company grants derivative options on the stock as opposed to direct stock grants. These options, which take the form of standard call options, allow the employee the right to purchase the shares of the company for a set price for a limited time. An employee stock option agreement will contain a complete description of the terms of ESOPs for that employee. Employees who engage in ESOPs have the option to buy shares later, i.e., after the vesting period.

Under Section 2(37) of the Companies Act, 2013, the term "Employee Stock Option" (ESOP) is defined as the option granted to directors, officers, or employees of a company or of its holding company or subsidiary company, if any, giving them the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a predetermined price.[1]

Understanding ESOPs

It is important to understand what is employee stock options before delving deeper into the mechanism of employee stock options and its legality.

ESOPs, are given out as direct stock, profit-sharing schemes, or bonuses, and it is entirely up to the company to decide who is eligible to participate.[2]

Employee stock ownership plans, are basically the options that could be bought at a certain price before the exercise date. Employers must ensure that the guidelines and restrictions outlined in the Companies Rules are followed while offering employee stock option plans to their employees.[3]

The employee has the opportunity to subscribe to and participate in an ESOP at his or her exclusive discretion.

Employers can obtain a number of benefits through ESOPs, such as tax advantages, which encourage employers to give such ESOPs to their employees and therefore help with employee retention, which leads to higher productivity.

Advantages of ESOPs for the Employees

- Nominal Shares

When exercising their ESOP rights, employees frequently pay a nominal fee to purchase the shares that is allotted to them. This means that the employees purchase the shares of the company at a reduced price which is a long-term wealth creation.

- Ownership

Employee stock ownership plans (ESOPs) give employees the opportunity to own stock in the company, which is advantageous for them in such a way that employees acquire voting rights in the company's management by becoming shareholders given that those ESOPs are converted into equity shares.

- Dividend Income

Shareholder dividends are distributed from a portion of the company's profits. Therefore, in addition to directly benefiting from their contributions to the success of the company, employees can earn additional dividend income.

- Employment Stability

Employee engagement and efficiency increase as a result of the stability of the employment provided by the vesting period.

Advantages of ESOPs for the Employer

- Productivity growth

Since an ESOP gives employees a stake in the company, they will have a sense of ownership and will benefit right away from the company's success. As a result, they become dedicated and work harder which benefits the company to development, which also indirectly benefits the employer.

- Retention of Employees

Any corporation could use ESOPs as a possible source of employee retention. Employee stock ownership plans (ESOPs) give employees a stake in the business, which may encourage them to work there longer to maximise earnings.

- A Strategy for Attracting New Talent

ESOPs are supplemental compensation plans that help businesses find and keep outstanding employees. In fact, ESOPs in India help start-ups recruit top talent in the early stages of their establishment when offering greater salary packages may not be a particularly practical alternative for them.

Advantages of ESOPs for the Corporate

Employee stock ownership plans produce favourable results for the company as well as for the employees. The annual employment growth, the annual sales growth, the likelihood of the company surviving; a better share price for the business and, ultimately, a greater balance in each employee's ESOP account results from organisational success, and the favourable Indian employment laws are also fruitful to the company.

Types of Employee Stock Option Plans

The following list of the four basic types of employee stock option schemes which helps in understanding how employee stock options work:

- Plan for Employee Stock Purchases (ESPP)

Under this, the company grants shares to the employees at a price much below their true market value. This builds up the interest in employee to work efficiently.

- Employee Stock Option Program (ESOS)
  The ESOS gives the employee options based on a predetermined valuation that is limited by a vesting schedule and performance criteria. The employee may exercise options to acquire shares after the vesting period has passed by paying the specified exercise price.
- Restricted Stock Units (RSU)
  In this, shares in the company are only given to the employee upon the occurrence of an event. RSUs often have no vesting requirements or exercise costs.
- Rights to Stock Appreciation (SARs)
  Since the company pays cash in return for the shares in this type of ESOP if the condition is met, technically, this is not an ESOP. However, a number of businesses adopt SARs as the ESOP model.

Tax Implications

ESOPs in India offer a wide range of valuable tax benefits for businesses and their owners. The plans benefit employees fairly and generally, as per ESOP rules and Indian employment laws.[4]

The exercise of the employee option to purchase shares at the Exercise Price triggers the first step of the two-stage taxing process for ESOPs, and the sale of the shares triggers the second stage. When an ESOP option is first exercised, the employee's possession of the difference between the Exercise Price and the security's market value is considered a requirement, that is the difference amount forms the part of the employee’s salary. When an employee chooses to exercise the option at source, the employer is required to deduct tax from their pay, inclusive of such difference amount, as it is a requirement.

The difference between the selling price of a share and the fair market value on the day the share was exercised is subject to capital gains tax upon the sale of the shares by the employee in the second stage.

An ESOP that is granted by a foreign corporation to an Indian resident will be taxed there. The agreement for the avoidance of double taxation (DTAA) and the tax laws of the company's home country must also be researched to ascertain the exact tax ramifications.

Giving ESOPs to potential employees has no tax repercussions. However, if one spends money on ESOPs, one can deduct those costs from the business income and deduct them from taxes.

ESOPs are taxable when they are exercised by the employee in accordance with their tax bracket.

After the employee sells the shares, any profit is considered capital gains. Similar to any other acquisition or sale of stock, a 15% capital gains tax is applicable on the capital gains if the shares are sold within a year.

If the capital gains are long-term (lasting longer than a year), 10% tax without indexation advantage or 20% tax with indexation benefit must be paid. Thus, Indian Employment Laws favour ESOPs.

Conclusion

The Employee Stock Option Plan is a proven employee retention tactic that involves giving stock options to employees to encourage their loyalty and motivation. It grants employees stock in the business. An agreement known as a stock option just grants an investor the right but not the obligation to purchase or sell stock at a predetermined price and date.

Many businesses, both start-ups and existing businesses, have always viewed employee stock ownership plans (ESOPs) as an excellent alternative, particularly as a way to retain employees, which benefits both the employees and the corporate. But before offering the ESOP option to its employees, every company must take into account all considerations related to how the ESOPs need to be distributed, to which employees, and the tax consequences associated with the same. The employees must also be aware of ESOPs, including what is Employment Stock Option Plan, how employee stock options work, what benefits it offers, and the tax implications.

Additionally, ESOP may seem like a nice addition to the benefits package for employees, but employees must first completely understand them in order to reach their full potential. In conclusion, if an ESOP is properly executed while taking all the variables into account, including the legal requirements involved in it, it may be a useful strategy for both employers and employees. So, in addition to giving employees financial rewards, an ESOP also encourages a sense of community and ownership among them.

FAQs

Are ESOPs beneficial for employees?

ESOPs, also known as employee stock option programmes, are arguably the most significant type of employee remuneration. From a start-up perspective, it aids in maintaining liquidity, and from an employee's perspective, it serves as a loyalty incentive.

Why would a company have an ESOP?

The buyers from the outside are most often not equipped to understand the true worth and merits of the company. The employee stock ownership plan produces favourable results for the company as well as for the employees.

Can an Employment Lawyer assist in formulating ESOPs?

An Employment Lawyer is capable of providing end-to-end legal services and assistance to help businesses create, and manage ESOPs. Consulting an Employment Lawyer, with a team of experienced professionals such as fromKing Stubb&Kasiva Advocates and Attorneys that can help one understand the benefits and drawbacks of implementing ESOP in a particular circumstance.

[1] The Companies Act, 2013, Section 2(37)

[2] https://www.sebi.gov.in/sebi_data/attachdocs/1289549364138.pdf

[3] https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf