

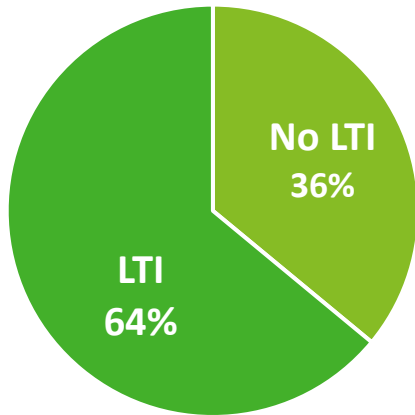
Navigating ESOPs before IPO

December 2024

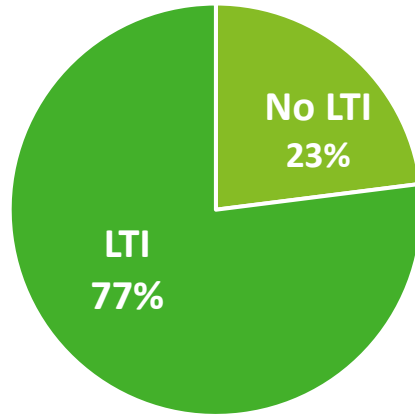
ESOP – India Landscape

Number of stock based LTI Plan (% of companies)

2018

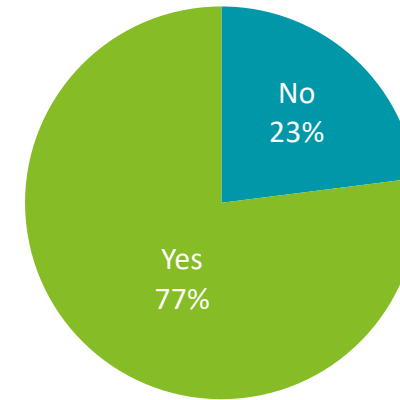


2023



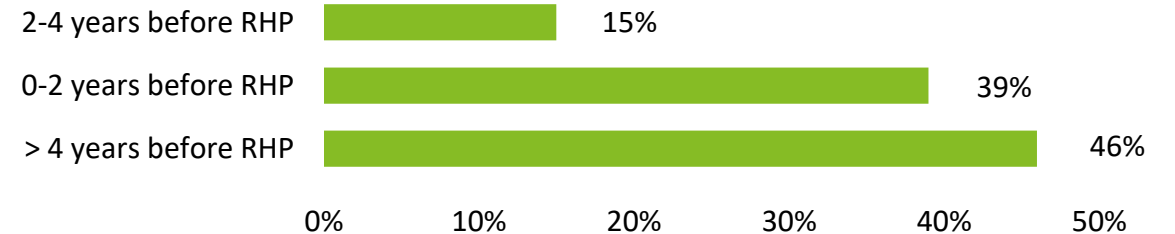
“Trends indicate that start ups are inclining towards ESOPs, long standing companies with large employee data base continue to recognize ESOPs as a part of their overall compensation summary”.

PREVALENCE OF LTI PLANNING



(Sample Size:60)

Of the studied companies that went public in the last three fiscal years, more than 50% introduced long-term incentives in the form of stock grants four years before an initial public offering



(Sample Size:46)

What's coming up?

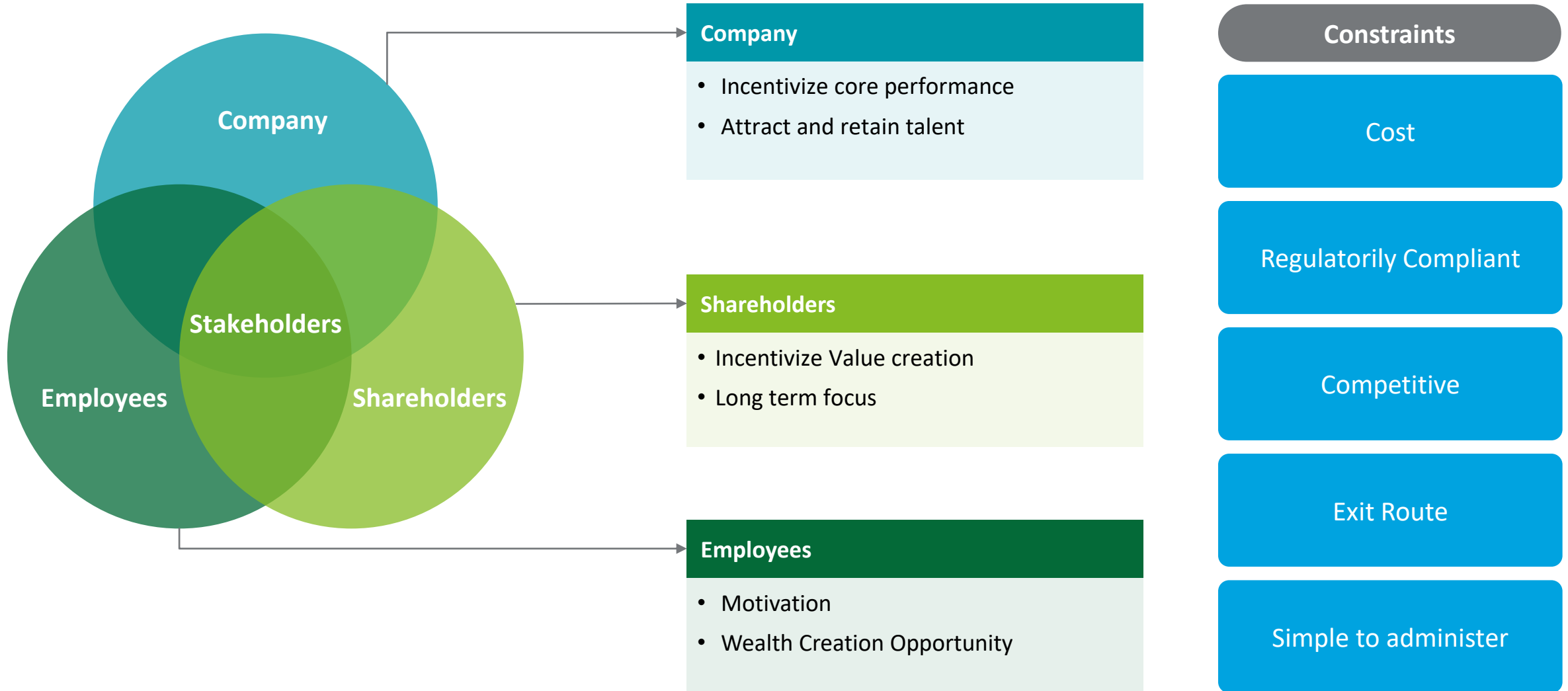
- 1 ESOPs: Basics, benefits and their role Pre-IPO
- 2 Regulatory & Tax Implications in India
- 3 Granting ESOPs to overseas employees
- 4 Accounting and Reporting impact
- 5 Navigating Success –Insights from Industry experts
- 6 Q & A



Polling Question 1

Key Considerations

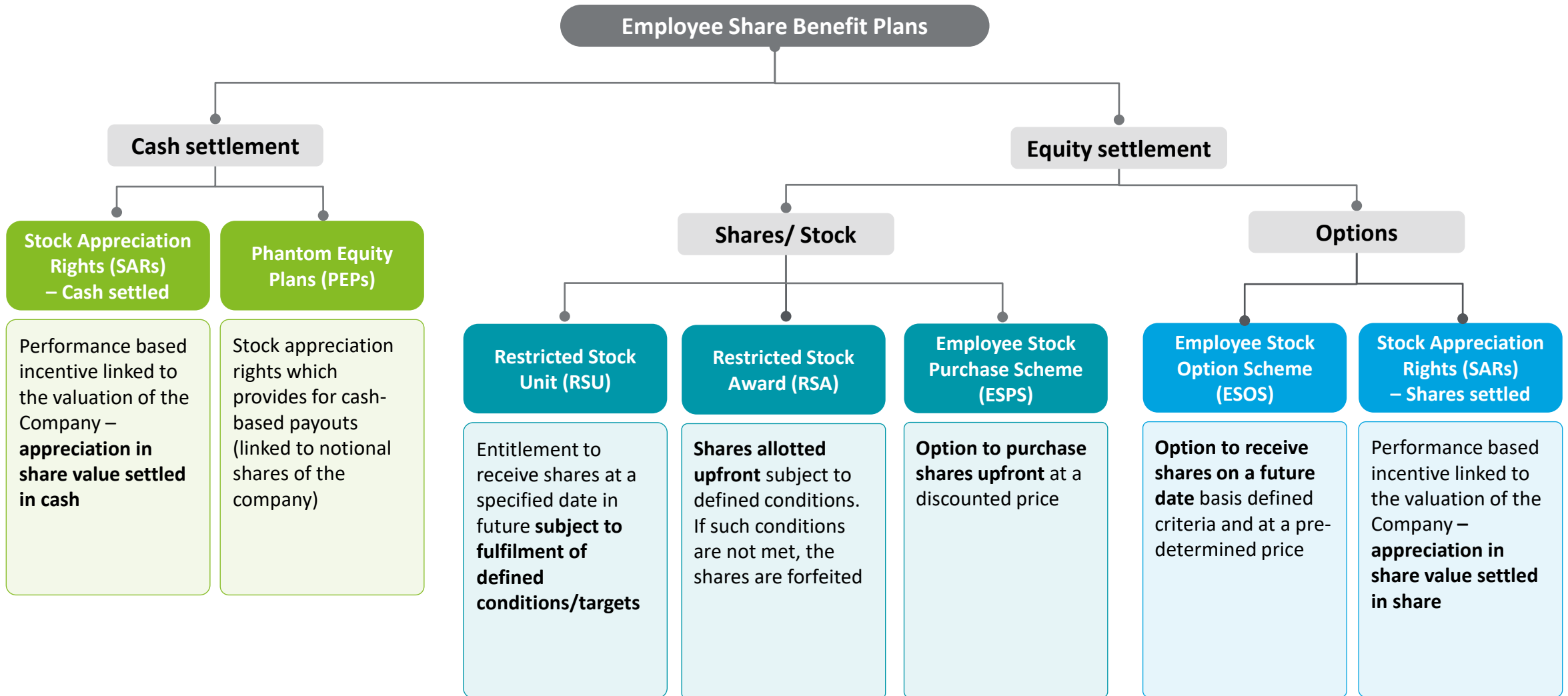
A good Long Term Incentive Plan should align interests of stakeholders within identified constraints



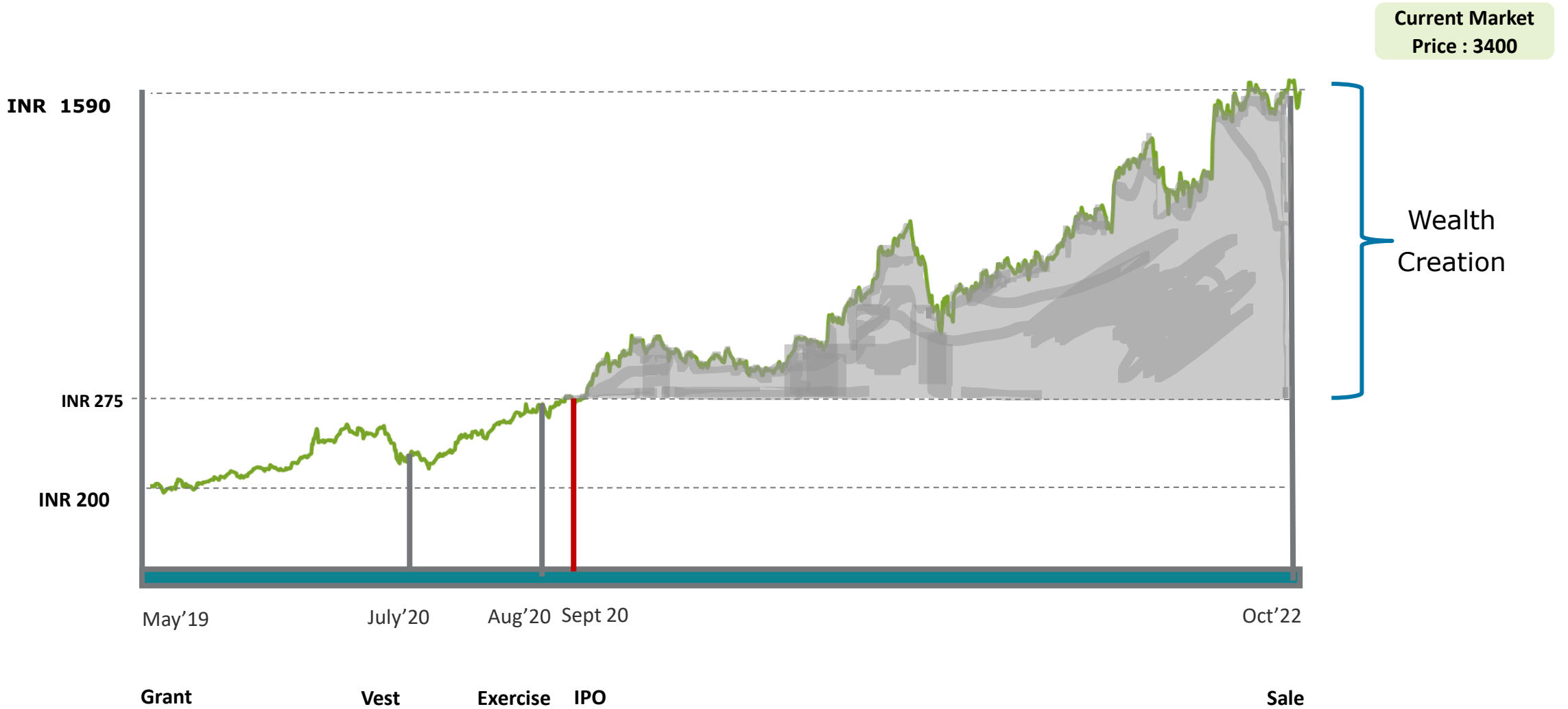
Why Companies Look at Pre-IPO Long Term Incentive/Stock Option Plans?

Sr. No.	Reasons for Pre-IPO Plans	Considerations for LTI Plan
1.	Attract and Retain Top Talent	<ul style="list-style-type: none">• Long term incentives are an important lever to retain existing top talent till IPO and beyond, and also to attract top talent from outside
2.	Reward for value creation	<ul style="list-style-type: none">• Value discovery/unlocking through an IPO offers a mechanism where market price rewards employees' effort without the company necessarily incurring cash outgo
3.	Demonstrate Management Stability	<ul style="list-style-type: none">• In pre-IPO roadshows, analysts/institutional investors often ask about the existence and nature of long-term incentive program• Such programs help demonstrate that management is incentivized to stay longer and create value for shareholders
4.	Incentivize Effort and Performance	<ul style="list-style-type: none">• Pre-IPO journey may require several roleholders to go above and beyond their normal role requirements, over an extended period of time• Pre-IPO ESOP grants is one key way to recognize and incentivize this performance

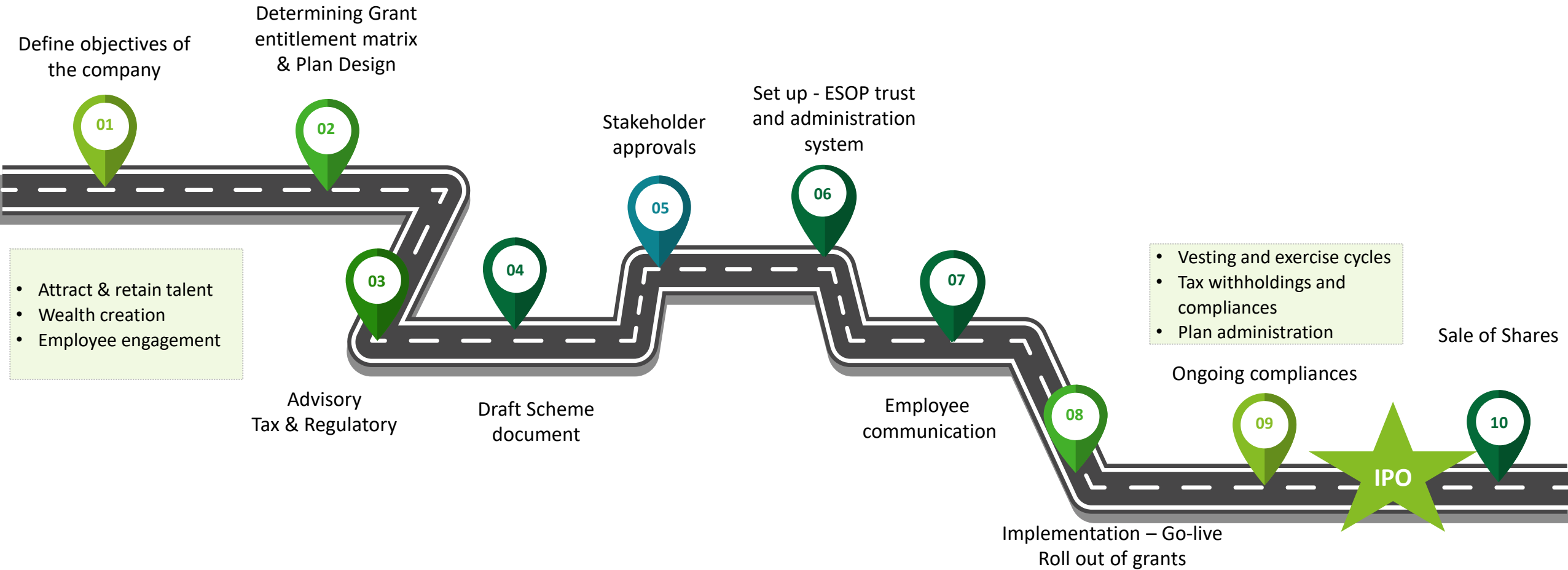
Popular Plans



Case Study



ESOP - Journey in brief



Regulatory Framework



Regulatory – Companies Act, SEBI Guidelines

- A Stock Plan for an unlisted company is formulated in accordance with the Companies Act.
- Listed Companies need to in accordance with the SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021. As the plan involves the issuance of shares, stock plans of unlisted companies must be amended to ensure compliance with SEBI guidelines.



Accounting

- Accounting for stock awards issued to employees is as per applicable accounting framework.
- In case options are issued to employees of overseas subsidiaries, adjustment of cross-charges would also arise.



Income-tax Act

- A stock award, being a benefit granted to an employee, triggers payroll taxation.
- From a corporate tax perspective, the deductibility of the related expense for the employer is important.
- When options are granted to employees of overseas subsidiaries or branches, issues such as cross-charges, tax withholding, TCS, and transfer pricing may arise.



Exchange Control

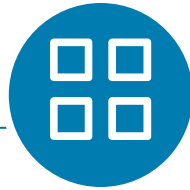
- Stock awards granted to foreign nationals or employees of overseas subsidiaries trigger compliance requirements under the exchange control regulations .



Other Considerations

- Due consideration for local laws in overseas jurisdictions is essential when granting awards to employees overseas. This ensures compliance with local regulations while optimizing costs and maximizing returns for employees

Companies Act

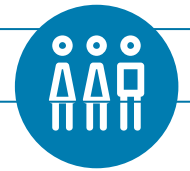


Operational Matters

- The issuance of ESOPs have to be approved by the shareholders through a special resolution
- The explanatory statement has total number of options granted, classes of employees entitled for stock, period of grant and vest, exercise price etc.
- Grants of options to employees of subsidiaries, also requires a special resolution
- Vesting period of at least one year is required



- The company has the freedom to determine the exercise price in accordance with the accounting policies
- A special resolution is required for varying in the terms of plans in respect of unexercised options provided such change is not prejudicial to the interest of the employees
- Options granted are not transferable or sold or pledged mortgaged etc.
- The directors report must contain all details of the scheme like option granted,, exercised, lapsed, forfeited, exercise price, variation in the terms etc.



Who is eligible to Participate

- Permanent employees of the company
- Employees of its holding/subsidiary company working in India or outside
- A director of the company, whether a whole-time director or not but excluding an independent director; or




Excluded employee

- An employee who is a promoter or a person belonging to the promoter group;
- A director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten per cent of the outstanding equity shares of the company.

Provided in case of specified start-ups these conditions would not apply for a period of 10 years from the date of incorporation

SEBI Regulations - Framework




Applicability & Coverage

- SEBI Guidelines apply to stock based plans of listed companies
- These guidelines cover all stock-settled plans.
- Shareholder approval for the scheme is required by a passing special resolution

Types of Plans :

- ESOS
- ESPP
- Share settled SARs
- General Employee Benefit Schemes
- Retirement Benefit
- Sweat Equity Shares




Eligible to participate

- Employees of the company
- Director of the company (whole-time/ part-time)
- Non-executive director (not part of promoter group)
- Employees of subsidiary / associate companies
- Employees of group companies

Excludes :

- Promoter; Person who is part of the promoter group
- Director who holds more than 10% of the outstanding shares of the company either by himself or through his relative or through a body corporate controlled by him.
- Independent director
- For specified start-ups approved by the DPIIT the exclusions for a promoter and director shall not apply for 10 years from the date of incorporation or registration.

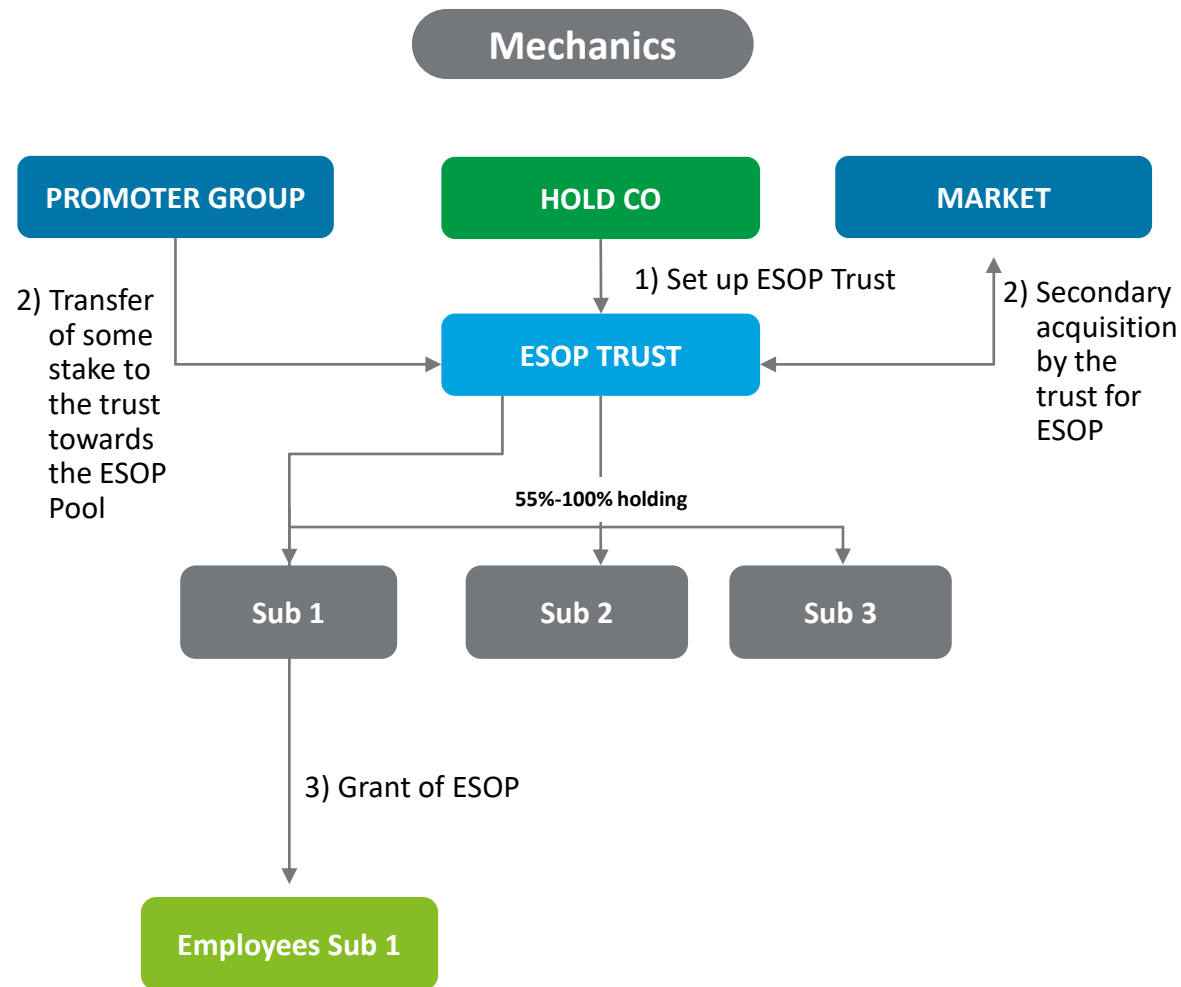


Other Norms

- A compensation committee may be constituted for administering the scheme having at least three directors of which at least half should be independent directors
- A minimum one year vesting period and lock-in period of one year is required except in certain circumstances

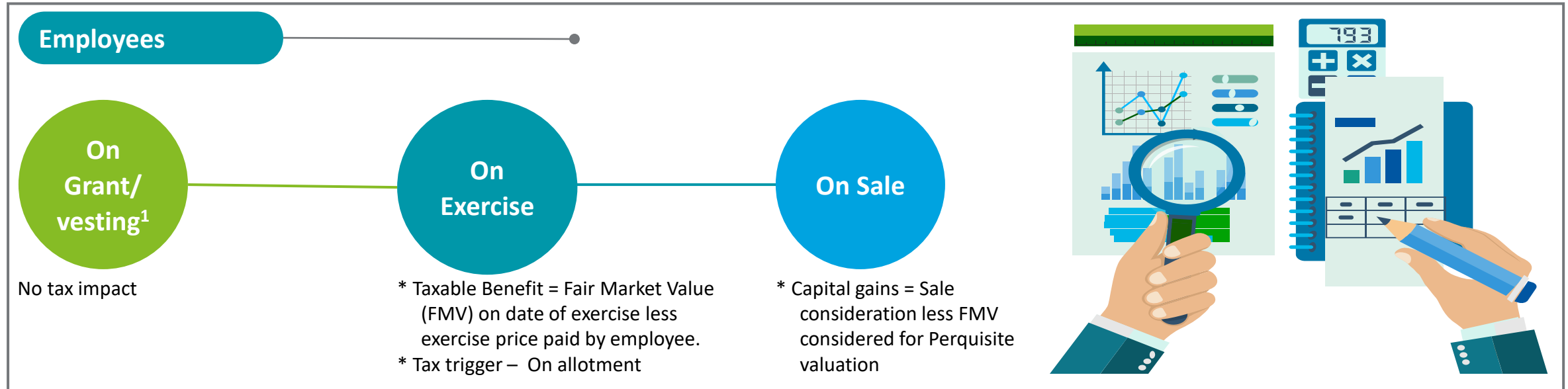
- The company is free to determine the exercise price of the shares which should be more than or equal to the Face value of the shares
- Variation to the scheme for unexercised options can be done by passing a special resolution provided the change is not prejudicial to the interest of the employees

SEBI Regulations - Trust



- Direct allotment of shares is possible where the company issues shares from an earmarked equity pool directly to the eligible employees.
- As an alternative, a company can also issue stock awards through secondary acquisition of shares from the market or vide a gift/ transfer from the promoter group. In such case SEBI guidelines mandate a Trust.
- As you can see in the adjoining diagram, the company can set-up an irrevocable Trust. The issuance of stock to the employees would be done through the ESOP Trust. The trust would also hold the shares transferred or gifted by the promoter group or those that are bought from the market. The company can lend monies to trust for this purpose. The employees of company, its subsidiary and the step down subsidiary are eligible for participation in the stock plan.
- Promoters, KMPs, directors or persons holding more than 10% stake in the company cannot be appointed as trustees. They would not be able to vote for the shares of the trust
- The guidelines provide a limit for acquisition of shares under secondary acquisition mode.
- The trustees should ensure that the trust does not become a mechanism for trading in shares and hence shall not sell the shares in secondary market except under the following circumstances:
 - (a) to enable the employee to fund the payment of the exercise price,/ tax obligations
 - (b) as the part of SAR or other schemes
 - (c) As a part of the buyback/ open offer/ delisting etc.

Income tax



¹ When vesting coincides with exercise/ allotment, taxation incident is on vesting.

Employer (Domestic Employees)

- Determination of FMV as per Rule 3. For unlisted companies, a Merchant banker valuation would be necessary
- Tax withholding similar to remuneration income on allotment of the shares and reporting in the form 16

Mobile Employees

- Employment income accrues at the place where services are rendered.
- Hence pro-rata benefit that relates to the India service during the vesting period would be liable to tax in India for employees on overseas assignments

Income-tax - Illustration

ESOP – Pre IPO

Computation of perquisite value	Income
FMV of shares on date of exercise (Aug 2018)	275
Less: Cost of Acquisition (May 2018)	200
Perquisite value taxed as Income from Salaries	75
Tax @ 30%	22.5

Computation of Capital Gains	Income
Sale Consideration (Oct 2022)	1590
Less - FMV considered for perquisite valuation	275
Capital Gains – LTCG	1315
Tax @ 10%	131.5
Total Tax Outflow	154



Income-tax - Illustration

ESOP – Post IPO

Computation of requisite value	Income
FMV of shares on date of exercise (Oct 2021)	1300
Less: Cost of Acquisition (May 2018)	200
Perquisite value taxed as Income from Salaries	1100
Tax @ 30%	330

Computation of Capital Gains	Income
Sale Consideration (Oct 2022)	1590
Less - FMV considered for perquisite valuation	1300
Capital Gains – LTCG	290
Tax @ 10%	29
Total Tax Outflow	359



Income tax

Deductibility of ESOP cost for Corporate tax has been a subject of litigation.

Latest Judicial Precedence

Historical Ruling in Favor of Taxpayers

- The Biocon ruling by the Bangalore ITAT, upheld by the Karnataka High Court, favored taxpayers on the deductibility of ESOP expenses.

Supreme Court Review Pending

- The tax authorities have filed a Special Leave Petition against the Karnataka High Court's ruling.
- The Supreme Court has issued a notice, and the matter is pending adjudication and conclusion.

Recent Disallowance by Lower Tax Authorities

- Lower tax authorities have started disallowing ESOP expenditures, categorizing them as capital expenditure due to short receipt of money against share issuance.

Alternative Treatment of ESOP Expenses

- In some cases, ESOP expenses are also being classified as capital expenditure related to the issuance of own shares, leading to denial of deductions.

Other decisions

- Lemon Tree Hotels Limited (Del HC)
- Biocon Limited (Kar HC)
- PVP Ventures Ltd. (Mad HC)

Considerations

Availability of supporting documents

- Accounting treatment in line with the Accounting Standards
- ESOP plan detailing the units granted, vesting conditions, and exercise price (if applicable)
- Grant letter issued to employees
- Calculations of ESOP discounts and graded vesting expense
- Valuation report as of the grant and exercise dates



Issue of Stock Options to Overseas employees

When issuing stock options to overseas employees, it is essential to ensure the plan complies with local regulations to benefit from favorable provisions in the respective jurisdictions.

Prior to allotting stock, the Indian company should review the requirements for recharges and the potential for deductions in the overseas jurisdiction.

Tax Favored Plans

Certain jurisdictions have specific requirements that, when met, offer advantages to either the employer or the employee.

Example

US 409A Compliant Plans: Regulation 409A of the IRC governs deferred compensation paid by an employer to an employee, including stock options and RSUs (free shares).

Non-Compliance Consequences:

- If the plan is not 409A compliant, tax at 37% is triggered at the time of vesting, even if the options are not exercised.
- The appreciation value of the shares is taxed at 37% annually until the options are exercised.
- A penalty of 20% is applied, making the total tax rate 57% on appreciation until exercise.

Employer Responsibility: The employer is required to withhold taxes.



Country Appendix

Israel: Trustee Plan for ESOPs

- A trustee plan is advisable to allow the Israeli subsidiary to claim tax deductions for ESOP costs.
- Implementation requires adopting an Israeli sub-plan to the parent ESOP plan.
- The sub-plan must be filed for approval with the Israeli Tax Authority (ITA).

Sweden: Qualified Stock Plans

- Qualified stock plans offer tax benefits if specific conditions are met.
- To optimize benefits for employees, ensure the plan complies with these conditions.

Social Security

- In most overseas jurisdictions the benefit arising from stock plans is subject to social security contribution in addition to tax withholding.

Exchange Control

For issue of Stock Options to employees of overseas subsidiary, the FEMA regulations need to be complied with.

Sectoral Caps and restrictions

Evaluate Quantum and Sectoral Limits

- Before extending the Indian plan to overseas subsidiaries, assess the quantum of stock issuance.
- Check sector-specific limits applicable under relevant regulations.

Restrictions in Certain Jurisdictions

- Stock issuance may be prohibited for citizens of some countries.
- For eligible employees in such jurisdictions, grants must be settled through cash payouts instead of shares.



Other formalities

Compliance Requirements for Overseas Beneficiaries

- Overseas beneficiaries may need to open accounts in India for transfer of securities, obtain No Objection Certificate (NOC) for tax deduction, may also need tax filings in India.

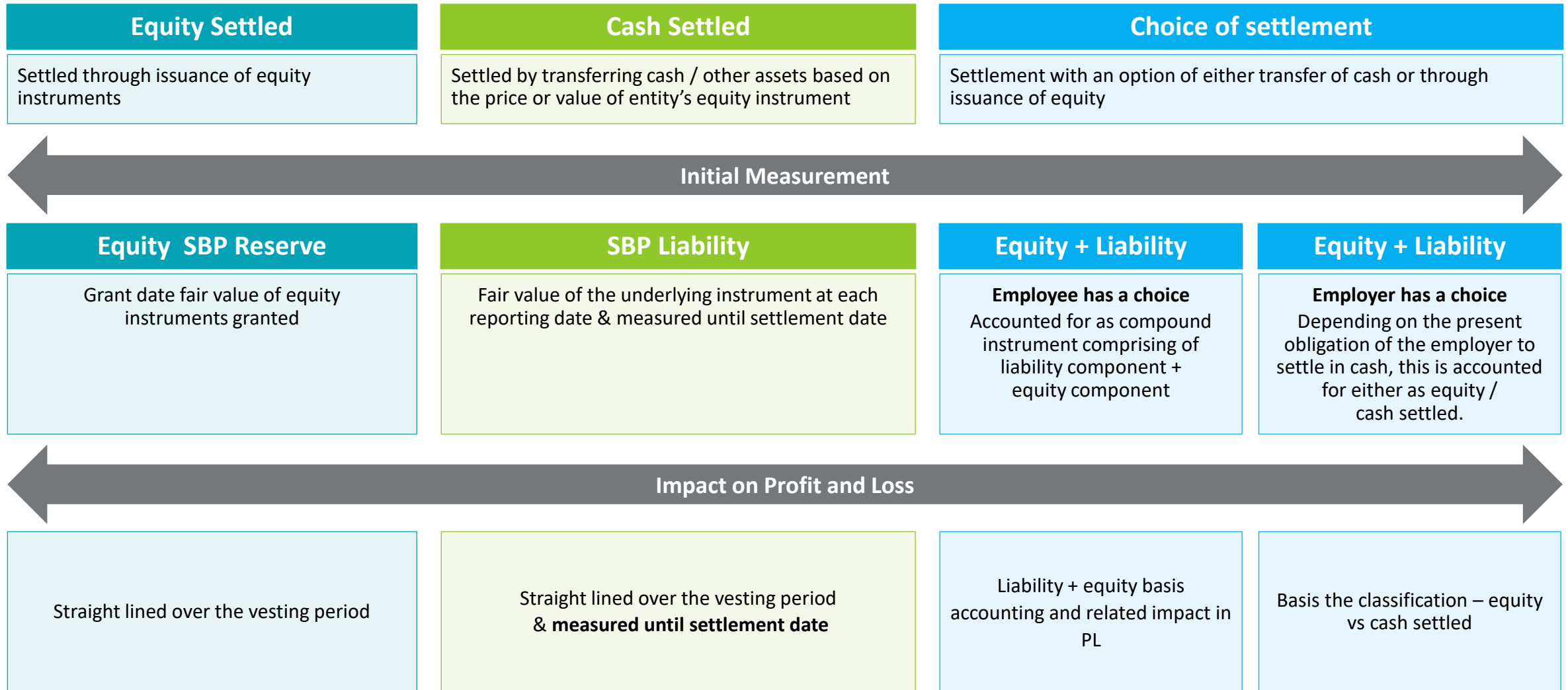
Double Taxation and DTAA

- Beneficiaries may face taxation in both India and their home jurisdiction.
- They would need to utilize provisions under the Double Taxation Avoidance Agreement (DTAA) between India and the other jurisdiction.

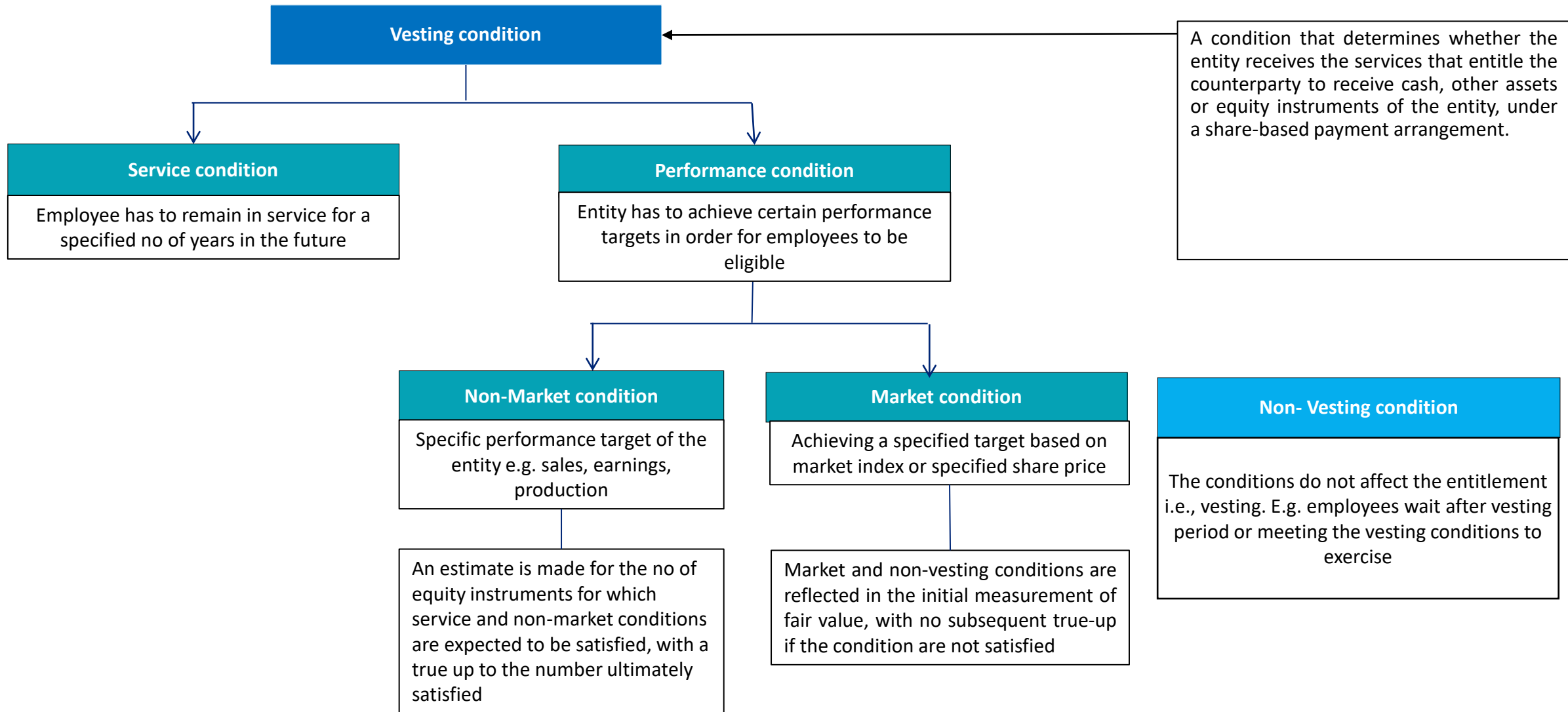
Reporting Obligations

- Compliance with reporting requirements in both jurisdictions is essential to avoid penalties.

ESOP accounting



Vesting and Non-vesting conditions



Additional points for accounting consideration

- **Variable vesting period**

The length of the expected vesting period needs to be estimated

- **Market condition with variable vesting period**

The length of the expected vesting period estimated initially is not revised subsequently

- **Non-market condition with variable vesting period**

The length of the expected vesting period is estimated based on most likely outcome of the performance condition. Subsequent revision to the estimate of the vesting period is required.

Example – Requirement for an exit event – IPO or sale combined with the condition that employee is in service until the exit event occurs

- **Intrinsic vs Fair value method of accounting**

The most common method used to calculate the fair value of ESOPs is the Black-Scholes Model, though other models like the Binomial Model or Monte Carlo method is applied considering the terms of the grant

- **Graded vesting**

Expense is recognized proportionally for each increment of vesting. This leads to a non-linear expense recognition over the vesting period.

Polling Question 2

Industry insights – Panel discussion

Q&A

Upcoming Webinar – January 2025

Global share plans – Design and regulatory considerations

Thank You!

Kindly spare a minute to help us with your valuable feedback for today's session...

For any queries, please feel free to write to us at intax@deloitte.com



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