taxsutra All rights reserved

taxsutra

ESOPs to NR Employees - Navigating through 'Tax Complexities'.

Jul 20, 2020

CA Maneet Pal Singh

Partner, I.P. Pasricha & Co.

It's not hard to look back and trace the emergence of the concept of Employee Stock Option Plans (ESOPs) among Companies. Not so long ago, the most classic way adopted by employers to retain their employees for a longer tenure was to reward their performance by way of grant of year-end bonuses, gifts and other perquisites. However, over time the trends have evolved and companies have started issuing ESOPs, where employees of a company are awarded with an equity stake in the company which gives them a sense of ownership. Infosys was among the first few companies to openly issue ESOPs to its staff. Mr. Narayan Murthy went on record and issued a statement saying-

"Every Indian employee at every level who joined the company on or before March 2010 is a stakeholder of Infosys".

In 1990s, Income tax was a critical factor that added more value to the already evolving ESOPs, making it more attractive. Being exempt from tax both- at the time of exercise of options as well as at the time of sale due to the then prevailing tax laws, the value of ESOPs multiplied compared to its alternative salaries and it became a household practice soon and there has been no turning back. Despite this exemption from payment of tax at the time of allotment of shares having been struck down in early 2000s, ESOPs still continue to be an attractive option as the employees get the benefit of stock ownership without making any upfront investments whatsoever.

The Economic Times issue dated 20th September, 2018, stated that Walmart was obligated to buy set of ESOPs worth nearly $ 800 million from its Indian acquisition, Flipkart. The total worth of Flipkart's ESOP was about $ 1.5 Billion based on the per share purchase price. However, their current employees will be allowed to liquidate 50 per cent of their vested ESOPs. No doubt, the ESOP re-purchase programme is a reward to employees of any entity for their service contribution[1].

What is ESOP?

The term 'Employee Stock Option' (ESOP) has been defined under sub-section (37) of Section 2 of the Companies Act, 2013, as the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

Rule 12 of Companies (Share Capital and Debentures) Rules, 2014 provides for criteria to issue ESOP in an unlisted or private company, which is not required to comply with Securities and Exchange Board of India- Employee Stock Option Scheme Guidelines. SEBI (Share-Based Employee Benefits) Regulations, 2014 are applicable for issue of ESOP in a listed company.

Who is an employee for the purpose of Section 62(1)(b) of Companies Act?[2]

1. A permanent employee of the company who has been working in India or outside India; or

Downloaded by @weboapps.com at 02/04/26 12:55pm

2. A director of the company, whether a whole time director or not but excluding an independent director; or

3. An employee as defined in clauses (1) or (2) of a subsidiary, in India or outside India, or of a holding company of the company but does not include- an employee who is a promoter or a person belonging to the promoter group; or

4. A director who either himself or through his relative or through anybody corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company.

Regulations Governing ESOP to Person Resident Outside India

As per the FDI policy read with The Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 and amendments thereto, ESOPs could be issued by an Indian Company to the following people who are resident outside India:

a. Employees/directors of an Indian company; or

b. Employees/directors of its (a) holding company; (b) joint venture; or (c) wholly owned overseas subsidiary/subsidiaries

Conditions for Issue of ESOPs to Foreign Employees

RBI vide Notification No. FEMA.344/2015 RB dated June 11, 2015 made certain amendments in the RBI regulations with reference to the provisions governing the issue of ESOP by listed and unlisted companies.

Prior to the amendment, an Indian company could issue shares under an ESOP scheme to its employees or employees of its joint venture or wholly owned overseas subsidiary/subsidiaries who are resident outside India, directly or through a trust, provided the scheme had been drawn in accordance with the Companies Act or SEBI Regulations as the case may be. In addition to this, the face value of the shares allotted under the scheme to non-resident employees could not exceed 5% of the paid up capital of the issuer[3].

Now, an Indian company may issue ESOP to its employees/ directors or employees/directors of its holding company or joint venture or wholly owned overseas subsidiary/ subsidiaries who are resident outside India, provided that:

a. The scheme must comply with applicable SEBI (Share-Based Employee Benefits) Regulations, 2014 (for listed companies) or the Companies (Share Capital and Debentures) Rules, 2014 notified by the Central Government under the Companies Act 2013 (for unlisted companies and private companies), as applicable;
b. The issuance to non-resident employees/directors must be within the sectoral caps prescribed under the FDI Policy
c. If FDI in the relevant sector is permissible under approval route only, approval for issue of ESOPs is required to be obtained from the Competent Authority. For the purpose of this condition, if the person resident outside India was holding the ESOPs or Sweat Equity as an Indian citizen (i.e. before leaving India), then the same could be held by him on non-repatriation basis; and
d. Prior approval from Ministry of Home Affairs to be obtained, in cases of issuance of ESOP and/or sweat equity shares to any employee/director who is a citizen of Bangladesh or Pakistan.

NB: Govt. of India vide Press Note No. 3 (2020 Series)[4] on April 17th, 2020 have barred automatic investment into India by its neighbouring countries.

Prior to the amendment, a non-resident entity could invest in India, subject to the FDI Policy except in certain reserved sectors. However, a citizen of Bangladesh or an entity incorporated in Bangladesh could invest only under the Government route. Whereas a citizen of Pakistan or an entity incorporated in Pakistan could invest in India, but only with prior Government approval in sectors excluding defence, space, atomic energy or any other sensitive/ prohibited sectors.

Downloaded by @weboapps.com at 02/04/26 12:55pm

taxsutra All rights reserved

*The revised FDI Policy requires the Government's approval for any FDI made by an entity of any country which shares a land border with India or where the beneficial owner of such an investment is residing in or is a citizen of any such country. India shares its land borders with Pakistan, Bangladesh, Nepal, Myanmar, Bhutan, China and Afghanistan (**"Neighbours"**).*

Stages of ESOP

A. **Creation of ESOP Policy:** This is the first stage where a Company decides to create a policy of issue of ESOP to its employees etc. universally in the company.

B. **Implementation:** Second part is to comply with rules and regulations under law such as to obtain approval of the board or shareholders as the case maybe.

C. **Grant:** Then the ESOPs are granted to the employee by issuing grant letters.

D. **Vesting:** After the completion of pre-determined period of time and satisfaction of the vesting conditions, the employee becomes eligible to buy shares on the pre-determined price.

E. **Final Stage**

i. Cessation of employment/external factors: The option expires and no longer becomes viable if the employee has ceased to be an employee of the Company. Or if the Company is undergoing Merger, hostile takeover etc.

ii. Exercise: The shares are purchased and the employee becomes the owner of the shares.

Taxation of ESOPs

As stated earlier, taxation of ESOPs has constantly been emerging from the last two decades. Until 1989, there were no specific provisions for taxation of the ESOPS gains. It was casually taxed as perquisites in the hands of employees and was included in their salary. Post 1999 till March 2007, concession tax treatment was given to certain qualified ESOPs. The gains from the sale in this case were taxed as capital gains, where taxes were charged at a very lower rate. Second was the intermediate stage where it was subject to fringe benefit tax, though recoverable from employee. Post April 2009, the ESOPs are taxed as perquisite in the hands of the employee, freeing the employer from any tax liability.

The monetary transaction arises neither when the options are granted nor when they are vested in the employee, thus there is no tax implications till the exercise date (when the right to purchase is/can be exercised).

It is very common for the Multi-National Companies to offer ESOPs to their employees/directors in their home country as well as to the resident and non-resident employees/directors based overseas in foreign branches, representative offices, joint ventures and subsidiaries etc., where they are deputed. A foreign company can also offer share options to the employees/directors of its branch or subsidiaries in India or the company in which the foreign company holds shares. Thus, the taxation rules applied on such employees need to be examined to determine the taxability of such stock options.

The Income Tax Act has laid down the following two stages of taxation once the Scheme becomes exercisable:

1. Allotment

During the exercise period, when the stock option becomes enforceable and the employee exercises his option to purchase the shares, the notional income on such purchase becomes taxable as perquisite under the head Income from Salaries -Section 17(2)(vi) IT Act. The employer has to compute the perquisite value of the shares and deduct tax (TDS) on such amount. The value and the tax deducted shall be reflected in Form 16 and Form 12BA of the employee. The perquisite value of such shares is calculated as the difference between the Fair Market Value(FMV) of the shares on the date of exercise and the exercise price of shares at which they are actually purchased, which is usually pre-decided when

Downloaded by @weboapps.com at 02/04/26 12:55pm

taxsutra All rights reserved

the option is granted.

Eg- the exercise price in the grant was Rs. 100/- per share for 500 shares. The FMV on exercise date is Rs. 400/- per share. Thus the FMV is Rs. 200,000/- and the exercise price is Rs. 50,000, resulting in the perquisite value of share as Rs. 1,50,000/-, which will be taxed as income from salary of the employee and TDS shall be deducted.

2. Transfer/ sale

Over the period of time, the shares allotted to the employee are sold or transferred by him and the amount of profit or gains received from such transaction is taxable under the head of Capital Gains as per Section 45 of the IT Act. The amount of profit on such transactions is calculated as the difference between the FMV on the exercise date and the sale value of such shares. The FMV considered for determining the perquisite value is used as the Cost of Acquisition of shares. This ensures that the employee does not suffer cascading effect on perquisites already taxed as income from salary.

As per eg above- the FMV on exercise date was Rs. 2,00,000/- and the sale value is Rs. 600/- per share i.e. Rs. 3,00,000/-. Thus the amount of Rs. 100,000/- is the Capital Gain in the hands of the employee and is taxable accordingly.

The Capital Gain could either be the short term or the long term, depending on the holding of such shares. The FMV calculated for shares of Listed Company is the average of the opening and closing price on the date of purchase, which record the highest volume. The FMV for shares of Unlisted Company is determined by the Category I merchant banker, registered with SEBI.

In case the employee incurred a loss in the transaction, then it is allowed to be carried forward in the ITRs and to be adjusted with gains in future years. In case the employee chooses not to exercise his option to purchase shares, there shall be no tax implication at all.

The taxation challenges surfaces when the employee migrates from parent organization in one country to subsidiaries in another country, or in case a foreigner or a non-resident is employed in such subsidiaries also called internationally mobile employees. The major conflict is the apportionment of taxing rights between the countries.

Section 6 of the IT Act provides in detail the procedure to establish residential status of a person according to the number of days he has stayed in India in the relevant financial year. If a person is a resident, then his income, earned anywhere in the world, becomes taxable in India but in case of a non-resident or a resident who is not an ordinary resident, the taxes may have to be paid outside India. Though, from F.Y. 2020-21, the limit of minimum days of stay for a resident has been reduced to 120 days or more and for a resident and ordinarily resident, an aggregate period of 182 days or more, both applies only for an individual whose income (other than foreign source) exceeds 15 lakhs. The IT Act also provides under Section 9(1)(ii) that a person's salary income is taxable in India, if the services are rendered in India.

The complications arise in cases where regular share options are granted in the home country, being exercised by the employee in the host country, triggering both the home country and host country to levy tax on such allotment. Thus the issue is who should be allowed to levy tax in such cases or should both have the jurisdiction to levy tax on proportionate basis.

As per the OECD commentary, the general principle established is that the Income is taxable at the place where the employment is actually exercised, i.e. the employee is physically present and performing the activities[5]. Thus the ESOPs perquisites are taxable in the country on the basis of no. of days the services were rendered in that country.

Eg- X Ltd., a parent company, grants ESOPs of 300 shares @ Rs. 100 per share to the employee on 1st July 2018, with the condition that it would vest with the employee on 1st July 2019, if he remains in the services. On 1st April 2019, the employee is deputed to their foreign subsidiary. The vesting of ESOPs arises on the predetermined date of 1st July 2019 and were exercised on that day itself. FMV of the shares on 1st July 2019 was Rs. 200 per share, resulting in perquisite amount of Rs. 30,000, to be taxed.

Downloaded by @weboapps.com at 02/04/26 12:55pm

taxsutra All rights reserved

Tax in India will be from the date of grant i.e. 1st July 2018 to the departure date i.e. 1st April 2019, which means 275 days and tax in foreign country will be from date of arrival 1st April 2019 to the date of vesting 1st July 2019 i.e. 90 days. Thus the tax amount is divided in the proportion of the days.

Most of the countries in the world have their own specific set of tax laws and rules and such diversity must be respected while designing ESOP plan for the employees around the world. Though OECD supports the above stated allocation and apportionment principles, but Indian Judiciary has divergent opinion on this allocation principle.

Delhi ITAT bench has supported the proportionate taxing in the case of ACIT vs. Robert Arthur Keltz [6], where an employee of a USA registered company was granted ESOPs in 2004 which were to be vested in 2007, meanwhile he was deputed to an Indian liaison office of his co. in 2006 and later he exercised his ESOPs in 2007. He was taxed in India for such perquisite amount for the whole period of grant from 2004 to 2007, which was challenged and held by CIT(A) that only that portion of perquisite amount attributable to the services rendered in India shall be taxable in India itself, thus for the amount for period of 2006-07 only shall be taxable in India.

However, Hyderabad ITAT, in case of Makrand Garde vs. ACIT Circle 12(1)[7], held that the parent company had issued the shares to the employee of its Indian subsidiary and it treated the business of parent and subsidiary as one, thus the ESOPs granted were in regard to the duties rendered in India. This resulted in the tax liability on the entire perquisite value to be paid in India, including for the period during which the services were provided to parent co in the USA.

Recently, Hon'ble Tribunal of Hyderabad in Anil Bhansali vs. ITO[8] , held that in case the employee has the residential status of 'resident and not ordinarily resident' and has received stock option transfer proceeds from a company for partly working in India and partly working in some other country, then the tax levied in India is only to the extent of the services provided in India. Further specified that the income can only be a business and profession income, where the business was controlled wholly or partly in India and profession is set up in India.

Double Taxation

In case any employee of an Indian Parent Company has exercised the ESOPs in India and has duly paid the tax on the perquisite amount in India itself and later on supposedly the employee is deputed to any of the foreign subsidiaries and decides to sell or transfer the shares there, the income of capital gain arising out of such transfer shall be taxed in the foreign country. For such income usually the FMV is considered as the cost of acquisition but the foreign state recognizes the exercise price as the acquisition price. In such a scenario an employee would be subject to double taxation on the perquisite amount.

The foreign tax authorities have to be convinced about FMV as appropriate for cost of acquisition or the due credit to be provided in tax return for the amount of income already taxed and paid in India. To prevent this, many countries have developed Double Taxation Treaties, called Double Taxation Avoidance Agreement (DTAA), that allows any person to set off or claim credit of the already paid tax on the same Income, subject to be taxed in both countries. In India there are around 153 such agreements with different countries. The IT Act provides relief from double taxation under section 90 and 91, but in case of conflict, the provisions of DTAA supersedes IT Act.

As per DTAA between India and US - Article 13 of the agreement provides that each country can tax the capital gain income as per their domestic laws. Article 25 further provides that in the case an income is taxable in the US but is also taxed in India, the employee being a Resident of India, India shall allow a relief or credit for the tax already paid or the deduction on the tax of income, which shall not exceed the amount of tax already paid in the US.

Accordingly a Form 67 has to be filed providing details of the Income and tax already paid in foreign country to claim credit.

Cash Flow

The Union Budget 2020 addressed the cash flow issues in taxation of ESOPs provided by the start-ups.

Downloaded by @weboapps.com at 02/04/26 12:55pm

taxsutra All rights reserved

The employees are taxed at the time of allotment of the shares, which are basically notional gains and not an actual income in the hands of employee resulting in the cash flow issues for the employee who chooses not to sell their shares immediately or want to hold them for a longer term. Thus, the Budget provides a relief by deferring the burden of payment of tax on such perquisite amount for a period of 5 years or till they leave the company or sell their shares, whichever is earliest. Such benefit is available to the Start-Ups qualified under Section 80-IAC of the IT Act.

On the other hand, globally the issue of ESOPs in start-ups is handled by considering the liquidated value of ESOPs in fair market or in certain cases defer the taxation till the period of sale of such shares. Further, in India the investors believe that tax should be levied on the difference between the actual purchasing price and sale price, to avoid taxing the notional gains.

Conclusion

ü With the trend of ESOPs in the commercial world of internationally moving employees, its effects and taxation are the areas not to be neglected. The companies must be more diligent towards the divergent domestic laws, while framing the Stock Option Schemes. The main purpose of ESOPs is to make the employees feel invested in the development of the company but at the same time the employees must benefit to the fullest with these schemes rather than being stuck into complex calculations and assessments of their notional income and its taxability.

ü Another challenge that seems to be impacting the smooth utilization of ESOPs is the inconsistency in the interpretation of tax principles. It would be useful if CBDT issues any clarification to avoid such ambiguities on taxation of ESOPs under the new perquisite tax regime in the hands of globally mobile employees.

ü ESOPs in start-ups are a risky business. Issue of its taxation must be dealt with by the government with extreme sensitivity; else the growing culture of start-ups would take a hit and ESOPs might face discardment at the hands of employees…

---

[1] https://icmai.in/TaxationPortal/upload/DT/Article/21.pdf, Last accessed on June 29th, 2020.

[2] As provided under Explanation of Rule 12 Companies (Share Capital and Debenture) Rules, 2014.

[3]Refer Issue of shares under Employees Stock Options Scheme and/or sweat equity shares to persons resident outside India, RBI/2015-16/128 A.P. (DIR Series) Circular No.4 Dated July 16, 2015

[4] https://dipp.gov.in/sites/default/files/pn3_2020.pdf; Last accessed on 30th June, 2020

[5] https://www.oecd.org/ctp/treaties/31413358.pdf; Last accessed on June 30, 2020.

Downloaded by @weboapps.com at 02/04/26 12:55pm

taxsutra All rights reserved

taxsutra

[6] ITA No.3452/ Del/ 2011

[7] Makarand Gadre v. Asstt. CIT [2008] (Hyd.)

[8] [2015]

Downloaded by @weboapps.com at 02/04/26 12:55pm