Taxation of Employee Stock Option Plan (ESOP)

Introduction

When an employer offers securities to an employee under an Employee Stock Option Plan (ESOP) scheme, free of cost or at a concessional rate, it is taxable as a perquisite in the year in which the securities have been allotted to the employee.

However, the liability of payment or deduction of tax on such perquisite is allowed to be deferred in case of an employee of an eligible start-up. The value of the perquisite shall be its market value as on the date of exercising the ESOP, as reduced by the amount recovered from the employee. When securities allotted under ESOPs are subsequently transferred by the employee, the gains arising therefrom shall be taxable under the head 'Capital Gains'. [Section 17(2)(vi)]

Why are ESOPs given?

Generally, ESOPs are offered by employers as an award to employees in order to retain top talent. It acts as a motivational tool for employees, making them feel responsible for the performance of the company after owning a stake in it.

ESOPs are particularly popular among start-ups that cannot afford to pay high salaries to employees in the initial phase. ESOPs allow start-ups to employ highly talented employees at a relatively low salary amount with the balance being made up via ESOPs.

Tax implications of ESOPs

At the time of allotment of shares

Any company responsible for paying salaries to employees shall deduct tax at the time of payment of such salary at the average rate of tax. The definition of salary also includes perquisites provided by the employer to employees. The value of any securities allotted to employees either free of cost or at a concessional rate would be treated as perquisite.

The first tax instance shall arise at the time of allotment of securities.

When an employee exercises the option, the difference between the Fair Market Value (FMV) of the securities on the date of exercising of option and the amount paid by the employee for such securities, is taxable as perquisite. The fair market value of ESOPs shall be determined in accordance with the manner prescribed under Rule 3.

The FMV of the securities on the date of allotment is not relevant for the calculation of perquisite value. Instead, the FMV of securities at the time of exercising of option is considered.

The fair market value of the following securities allotted under the ESOP scheme shall be computed as per Rule 3:

a) Quoted shares; and
b) Unquoted equity shares.

Scenarios	Fair Market Value
Where shares are listed on one stock exchange on the date of exercising of ESOP	Average of the opening price and closing price of the share on that date on the stock exchange
Where shares are listed on more than one stock exchange on the date of exercising of ESOP	Average of opening price and closing price of the share on that stock exchange which records the highest volume of trading in the share
Where on the date of exercising of ESOP there is no trading in shares in the stock exchange	• The closing price of the share on the stock exchange on a date closest to the date of exercising of ESOP and immediately preceding such date; or • The closing price of the share on the stock exchange, which records the highest volume of trading in such share, if the closing price, as on the date closest to the date of exercising of the option and immediately preceding such date, is recorded on more than one recognized stock exchange.
Where shares are not listed on a stock exchange	Value of share as determined by a merchant banker on: • The date of exercising of ESOP; or • Any date earlier than the date of the exercising of the option, not being a date which is more than 180 days earlier than the date of the exercising.

For example, ABC India Private Limited issued ESOP to Mr. B during the financial year 2024-25. Calculate the value of the perquisite based on the following data:

Particulars	Amount
Date of granting of ESOP	01-04-2022
Vesting Period	01-04-2022 to 31-03-2024
Date of Exercise of ESOP	10-05-2024
Fair Market Value as on March 31, 2022	6,000
Fair Market Value as on May 10, 2022	6,500
Number of ESOP exercised	100
Pre-determined price to be paid by the employee to the employer	500
Value of perquisite [(Rs. 6,500 – Rs. 500) * 100]	Rs 600,000

At the time of transfer of shares by the employee

When securities allotted under ESOPs are subsequently transferred by the employee, the gains arising therefrom shall be taxable under the head 'Capital Gains'. The taxability of capital gains shall depend on the type of security and the period of holding thereof.

The period of holding of securities shall be the period commencing from the date of allotment of securities, and not from the date of exercising of option, ending on the date when employees transfer the securities.

Further, the fair market value of securities on the date of exercising the option shall be taken as the cost of acquisition of such securities to compute the capital gain.

For example, Mr. John exercised the ESOP on 01-04-2022, and the shares are allotted to him on 01-05-2022. He sold such shares on 01-04-2024. The period of holding of such shares shall be counted from 01-05-2022 (and not from 01-04-2022) till 31-03-2024. However, for computing the cost of acquisition, the fair market value of shares as on 01-04-2022, being the date of exercising of ESOP, shall be considered.

Tax treatment of ESOPs where the employer is an eligible start-up

The taxability of ESOPs arises in the hands of the employee at two stages. Firstly, when securities are allotted to the employee and, secondly, when the same is sold.

At the time of allotment of securities, the difference between the fair market value of shares on the date of exercising the option and the amount actually paid by the employee for such securities is taxable as perquisite and chargeable to tax under the head salary. Consequently, the employer is required to include the amount of perquisite in the salary of the employee and deduct tax thereon under section 192 in the year in which securities are allotted.

As employees do not get any immediate benefit from securities allotted under the ESOPs, the deduction of tax thereon in the year of allotment itself was very burdensome for them as it reduces the cash flow in their hands. To reduce the burden of taxes, various provisions of the Income-tax Act, inter-alia, Section 192 (TDS on salary), Section 140A (self-assessment tax), Section 191 (direct payment of tax by the employee), and Section 156 (notice of demand) amended to defer the deduction and payment of tax on income in the nature of perquisites arising from ESOPs.

Only an eligible start-up as referred to in Section 80-IAC and its employees would get the benefit of deferment of TDS and tax payment on perquisite arising from ESOPs.

Section 192, which provides for the deduction of tax by the employer from the salary of the employee, provides that an eligible start-up shall deduct tax from income arising in the nature of perquisites from ESOPs within 14 days from the happening of any of the following events (whichever is earlier):

a) On the expiry of 48 months from the end of the assessment year in which securities are allotted under ESOPs;

b) From the date the assessee ceases to be an employee of the organization; or

c) From the date of sale of securities allotted under ESOP.

For this purpose, the tax shall be deducted on the basis of rates in force for the financial year in which securities are allotted or transferred under ESOPs.

Thus, an employee is required to disclose the value of perquisite from ESOPs in his return of income for the year in which securities are allotted. However, due to the deferment of payment of tax, the employee shall not be required to pay tax on perquisites arising from ESOPs in such year.

The tax to be payable on the salary income, excluding the perquisite value of ESOPs, should be computed as per the following formula.

$$\textit{Tax payable on salary income excluding ESOPs perquisite} = \textit{Tax on total income including ESOPs perquisites} \times \frac{\textit{Total income excluding ESOPs perquisites}}{\textit{Total income including ESOPs perquisites}}$$

For example, Mr. A, working in an eligible start-up company, has been allotted 100,000 shares at the rate of Rs. 10 per share under the ESOP scheme in the Financial Year 2024-25. The fair market value of shares at the time of exercising of option by Mr. A is Rs. 100. The perquisite value of ESOPs taxable in the hands of Mr. A shall be Rs. 90 Lakhs [100,000 shares* (Rs. 100 – Rs. 10)]. The annual salary of Mr. A (excluding perquisite value of ESOPs) in that year is Rs. 40 Lakhs. He continues with the company even after the expiry of 48 months from the end of the assessment year in which shares are allotted and he does not sell the shares even after the expiry of said period. What shall be the mechanism for deferment of TDS and tax on the perquisite value of ESOPs in such a case?

a) *Assessment Year 2025-26*

Mr. A would be required to disclose the perquisite value of ESOPs, i.e., Rs. 90 lakhs in his return of income but he shall not be liable to pay any tax thereon in the year of allotment of shares. The tax to be payable on the salary income, excluding the perquisite value of ESOPs, shall be computed in the following manner:

Particulars	***Amount (in Rs.)***
Total Income before including perquisite value of ESOPs (A)	40,00,000
Add: Perquisite Value of ESOPs (B)	90,00,000
Total Income after including perquisite value of ESOPs (C)	**1,30,00,000**
Tax on Rs. 1.30 crores as per slab rates applicable for Assessment Year 2025-26 as per old taxation regime (D)	37,12,500
Add: Surcharge [E = D * 15%]	5,56,875
Add: Education Cess [F = (D + E) * 4%]	1,70,775
Total tax liability for Assessment Year 2025-26 after considering perquisite value of ESOPs [G = D + E + F]	44,40,150
Tax liability attributable to salary income (excluding the perquisite of ESOPs) [G * A/C]	**13,66,200**

b) *Assessment Year 2029-30*

As Mr. A continues with the company after the expiry of 48 months from the end of the Assessment Year in which shares are allotted and he does not sell the shares even after the expiry of said period, the liability to deduct tax or make payment of tax on perquisite value of ESOP will arise in the Assessment Year 2029-30, i.e., 48 months from the end of the Assessment year (2025-26) in which shares are allotted. The tax liability for the Assessment Year 2029-30 shall be computed as under:

Particulars	***Amount (in Rs.)***
Total tax liability for Assessment Year 2023-24 after considering the perquisite value of ESOPs	**44,40,150**
Less: Tax already paid at the time of filing of return for the Assessment Year 2025-26 excluding the tax liability attributable to ESOPs	13,66,200
Differential amount to be deducted or paid by the employer or employee in the Assessment Year 2029-30 towards the tax liability attributable to ESOPs	**30,73,950**

MCQs on Employee Stock Option Plan

Q1. Under an Employee Stock Option Plan (ESOP) scheme, an employer offers securities to an employee at ________, it is taxable under the Income Tax Act as ________.

(a) Free of cost or Concessional rate, Perquisites
(b) Free of cost or Concessional rate, Capital Gains
(c) Market Price, Perquisites
(d) Market Price, Capital Gains

Correct answer: (a)

Justification for correct answer: When an employer offers securities to an employee under an Employee Stock Option Plan (ESOP) scheme, free of cost or at a concessional rate, it is taxable as a perquisite in the year of exercising such option.

Q2. If securities allotted under ESOPs are subsequently transferred by the employee, the gains arising therefrom shall be ________.

(a) taxable under the head Salaries
(b) taxable under the head Capital Gains
(c) taxable under the head Other Sources
(d) Not Taxable

Correct Answer: (b)

Justification for correct answer: When securities allotted under ESOPs are subsequently transferred by the employee, the gains arising therefrom shall be taxable under the head 'Capital Gains'.

Q3. When an employee exercises the option, the difference between the ___________of the securities and _____________ is taxable as perquisite.

(a) Fair Market Value of securities, the price paid by the employee
(b) Price paid by the employee, Face Value of securities
(c) Either (a) or (b)
(d) Both (a) or (b)

Correct Answer: (a)

Justification for correct answer: When an employee exercises the option, the difference between the Fair Market Value (FMV) of the securities on the date of exercising of option and the amount paid by the employee for such securities, is taxable as perquisite.

Q4. While computing the income chargeable as perquisites, Fair Market Value shall be considered as on the date of _________.

(a) Allotment of shares
(b) Granting the option
(c) Exercising option
(d) Vesting the option

Correct Answer: (c)

Justification for correct answer: When an employee exercises the option, the difference between the Fair Market Value (FMV) of the securities on the date of exercising of option and the amount paid by the employee for such securities, is taxable as perquisite.

Q5. The period of holding in case of securities derived through ESOPs shall commence from the date of __________.

(a) Grant of options
(b) Exercising the option
(c) Allotment of securities
(d) Payment of tax on such perquisite

Correct Answer: (c)

Justification for correct answer: The period of holding of securities shall be the period commencing from the date of allotment of securities, and not from the date of exercising of option, ending on the date when employees transfer the securities.

Q6. In case of subsequent transfer of the securities by the employee, the cost of acquisition of those securities will be _________.

(a) Amount paid by the employee at the time of exercising the option
(b) Fair Market Value of the securities as on the date of exercising the option
(c) Fair Market value of the securities at the time of allotment of securities
(d) Either (a) or (b)

Correct Answer: (b)

Justification for correct answer: The fair market value of securities on the date of exercising the option shall be taken as the cost of acquisition of such securities to compute the capital gain.

Q7. In the case of an employee of an eligible start-up, tax shall be deducted from the perquisites within 14 days:

(a) On the expiry of 48 months from the end of the assessment year in which securities are allotted under ESOPs
(b) From the date the assessee ceases to be an employee of the organization
(c) From the date of sale of securities allotted under ESOP
(d) Earlier of (a), (b), or (c)

Correct Answer: (d)

Justification for correct answer: Section 192, which provides for the deduction of tax by the employer from the salary of the employee, provides that an eligible start-up shall deduct tax from income arising in the nature of perquisites from ESOPs within 14 days from the happening of any of the following events (whichever is earlier):

a) On the expiry of 48 months from the end of the assessment year in which securities are allotted under ESOPs;
b) From the date the assessee ceases to be an employee of the organization; or
c) From the date of sale of securities allotted under ESOP.

Q8. For the purpose of deduction of tax under section 192 in case of an employee of an eligible start-up, the rate of tax shall be the rates in force of the financial year in which:

(a) Employee exercised the option
(b) Securities were allotted
(c) tax is required to be deducted i.e. current year
(d) Either (b) or (c)

Correct Answer: (b)

Justification for correct answer: The tax shall be deducted on the basis of rates in force for the financial year in which securities were allotted or transferred under ESOPs.