ESOP Taxability

Startup Series #4

ESOPs are a common tool used by startups to attract, retain, and reward employees as it allows them to employ talented employees at a relatively lower salary during the initial stages. Given that the shares may not be liquid and may or may not be worth something in the future, but the tax liability was upfront, the Government has deferred the taxability of ESOPs offered to employees of Eligible startups.

*In continuation to our **'Startup Series',** let us look at the taxability on ESOPs offered to employees of eligible startups in **#4** of the series.*

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General ESOP taxation

The taxation of ESOPs is split into two instances in the hands of employees:

Income from Salary	**The difference between the Fair Market Value (FMV) on exercise date and exercise price shall be taxable as "perquisite".**		
	FMV on exercise date (A)	**Exercise price (B)**	**Perquisite (A) – (B)**
	Rs. 100	Rs. 60	Rs. 40
Capital gains	**The difference between the sale price and fair market value on exercise date is taxable as capital gains.**		
	Sale consideration (A)	**FMV on exercise date (B)**	**Capital gains (A) - (B)**
	Rs. 150	Rs. 100	Rs. 50

Generally, tax on perquisite is required to be paid **at the time of exercise of option** resulting in cash outflow in the hands of employees even though no cash is earned by the employees. Further, there is no certainty on how the entity would perform in the future and whether the shares would be liquid. To ease the same, the Finance Act 2020 amended the provisions to defer the payment of tax on ESOP allotted by **Eligible Startups** <u>**(refer definition in our alert #2).**</u>

ESOP taxation for Startups

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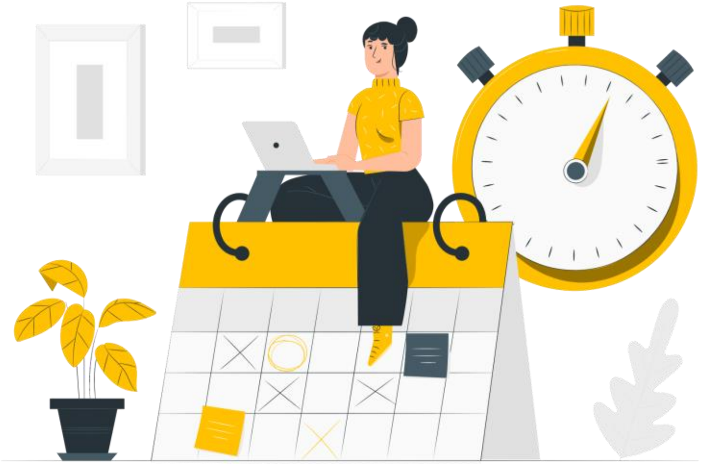
01 The eligible startup is required to deduct/ pay tax **within 14 days** from the happening of any of the below event whichever is earlier:



- After **the expiry of 48 months** from the end of relevant assessment year in which options were exercised, or
- From the **date of the sale of such specified security** or sweat equity share by the employee, or
- From the **date of cessation** of his employment

02 Though the payment of tax is deferred subsequently, the computation is to be done in the year in which shares are exercised as per Section 17(2)(vi) of Income Tax Act, 1961.

03 The tax shall be computed on the basis of rates in force of the financial year in which such ESOPs are allotted or transferred.

04 In case the employers fail to deduct tax, the onus would fall on the employee to pay the tax.

Issues yet to be addressed

The employees may still face cash flow problem even after 48 months, until the shares are sold by them. Therefore, the relaxation only provides temporary relief.

The relaxation does not apply to all the start-ups recognized by DPIIT but only to those companies which are set up between 1 April 2016 and 31 March 2022 and are approved by the Inter-Ministerial Board of Certification (‘IMB’) and hence narrows down the benefit.

The employee may resort to selling the shares granted under an ESOP just to fund the taxes if he ceases to be an employee of the company.

It is not clear for how long the condition of “eligible startup” be met i.e., should it be met even after exercise but before trigger event?

Stay tuned for more updates on Startups!

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In case you have missed the previous alerts, click on the hyperlinks to refer the same.

- #1 [Startup recognition]
- #2 [Tax holiday benefit]
- #3 [Angel Tax Exemption]
- #4 **Taxability of ESOPs**
- #5 **Carry forward of losses in case of change in shareholding**
- #6 **Capital gains exemption on investment in startups**
- #7 **Exchange control provisions**
- #8 **Labor law relaxations**
- #9 **Startup India Seed Fund**
- #10 **Other regulatory provisions / benefits**

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