



Employee Stock Option Plans (ESOPs) have become a key tool for Indian companies to attract, retain and motivate talent. But while they promise wealth creation for employees, they also create multi-layered financial and tax impacts — both for the company and its employees. This article aims to break down these impacts in a clear, practical way, backed by statutory references and a simple example.

### **Understanding ESOPs in India**

Under Section 62(1)(b) of the Companies Act, 2013, companies can issue shares to employees under an ESOP scheme, subject to compliance with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014.

For listed companies, SEBI (SBEBSE) Regulations, 2021 provide additional governance.

Put simply, an ESOP gives an employee the option (not obligation) to buy company shares at a pre-decided exercise price after a certain vesting period.

### **Financial Impact on the Company**

While ESOPs help conserve cash outflows by substituting part of salary with stock options, they do carry accounting and dilution implications:

1. **P&L Expense:**

As per Ind AS 102 (Share-based Payment), companies must record the fair value of ESOPs as an expense over the vesting period. This means that although there's no immediate cash outflow, the company's profits are reduced.

2. **Equity Dilution:**

When employees exercise their options, the company issues new shares, increasing share capital. This dilutes existing shareholders' percentage holding.

3. **Cash Inflow on Exercise:**

When an employee pays the exercise price, the company gets cash inflow — but this is usually much lower than the fair market value (FMV). So the company effectively parts with shares at a discount.

### **Example:**

Let's assume:

- Options granted: 10,000 shares
- **Exercise Price: ₹100 per share**



- FMV on Exercise: ₹500 per share

**Impact:**

- Cash inflow: ₹10 lakh (10,000 × ₹100)
- Equity dilution: New shares worth ₹50 lakh (10,000 × ₹500 FMV) added to capital base.
- P&L hit: The difference, i.e., ₹40 lakh, is amortised over vesting years.

**Taxation in the Hands of Employees**

Employees face a two-stage tax under Section 17(2)(vi) and Section 111A / 112A of the Income Tax Act, 1961:

1. Tax at the time of Exercise:

When options are exercised, the difference between FMV (on date of exercise) and exercise price is taxed as a perquisite under the head Salary. The employer must deduct TDS accordingly.

2. Tax at the time of Sale:

When the employee sells these shares, Capital Gains Tax applies. The cost of acquisition is the FMV considered for perquisite taxation. - If shares are listed and held for more than 12 months: LTCG @12.5% on gains above ₹1 lakh. - If held for 12 months or less: STCG @20%

3. For unlisted shares, LTCG @12.5% without indexation after 24 months applies.

**Example Working:**

- Shares vested & exercised: 1,000 shares
- Exercise Price: ₹100
- FMV on exercise date: ₹500
- Sale Price: ₹800 per share after 2 years (listed company)

**At Exercise:**

- Perquisite:  $(₹500 - ₹100) \times 1,000 = ₹4$  lakh (taxed as salary)

**At Sale:**

- Sale Proceeds: ₹8 lakh
- Cost of Acquisition: ₹5 lakh (FMV on exercise)
- LTCG: ₹3 lakh → Taxable @12.5% above ₹1 lakh threshold



### **Valuation — A Tax Risk Area**

Section 17(2)(vi) read with Rule 3(8) mandates that FMV must be determined as per Rule 11UA for unlisted shares — which often requires a merchant banker's fair valuation certificate to avoid litigation on perquisite value.

Listed shares' FMV is the average of opening and closing prices on the stock exchange on the date of exercise.

### **Compliance Musts for Companies**

- Board & Shareholder Approval under Section 62(1)(b)
- Maintain an ESOP Register
- File PAS-3 for share allotment
- Deduct TDS on perquisite value (Form 16)
- Disclose ESOP expense under Ind AS 102

Non-compliance can attract penalties under Companies Act and disallowance of expense under Income Tax Act.

### **Key Takeaways**

1. For Companies:

ESOPs are a non-cash way to reward talent but bring hidden costs — profit impact, dilution, and compliance effort.

2. For Employees:

While ESOPs create wealth, they bring tax at two stages. Planning when to exercise and sell can optimise tax outgo.

3. For Founders & CFOs:

Always back ESOP valuation with Rule 11UA-compliant reports to avoid tax disputes.

### **Final Thoughts**

In India's competitive talent market, ESOPs remain a valuable tool for startups and large companies alike. A well-designed ESOP scheme can align employees with the company's growth story — but ignoring the financial and tax nuances can create unintended costs for both parties.

Before rolling out or exercising ESOPs, employees and employers should consult tax advisors and ensure documentation and compliance are watertight.



**Affluence Advisory Pvt. Ltd.**  
**Financial Impact on Company & Taxation to Employees in ESOPs**  
**— A Practical Insight**

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Remember: In ESOPs, the “free shares” are rarely free — someone pays for it, and so does the taxman.

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