

Taxation and walk through for Employees' Stock Option Plan

Webinar organized by
Direct Tax Committee, ICAI
18th June 2026

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What is ESOP?

Indian Perspective

E – Employee

S – Stock

O – Option

P – Plan

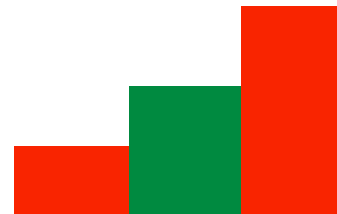
US Perspective

E – Employee

S – Stock

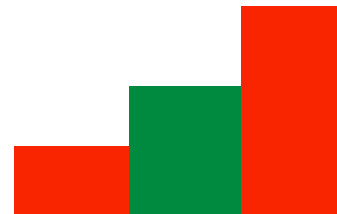
O – Ownership

P – Plan



What is Stock Option?

- Stock Option is a right given to an employee to buy certain number of shares of the company at a fixed pre-determined price over a period of time.
- It has 3 main characteristics:
 - The **number** of shares that can be bought is **pre-determined**.
 - The **price** at which shares can be bought is **pre-determined**.
 - The right is available over a **period of time**.



ESOP Lifecycle

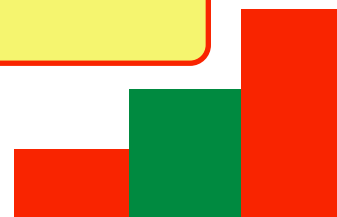
Conceptualizing & Designing

Legal Compliance

Employee Presentation

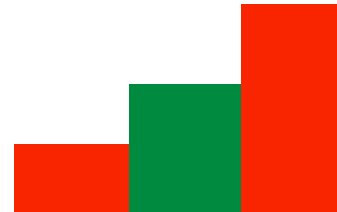
Implementation

Administration



ESOP Terminologies

- **Grant Price / Exercise Price** – The price at which shares are offered to the employees.
- **Vesting Period** – The period after which the options can be converted into shares.
- **Exercise** – The action of paying the price and converting the options into shares.
- **Exercise Period** - The period after vesting within which the employee has to take the decision of exercising Options.

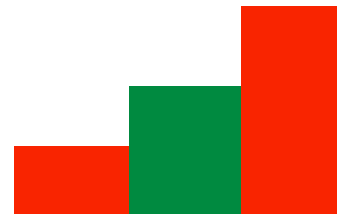


What is Vesting of Options?

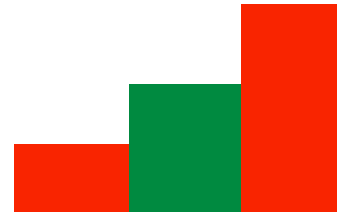
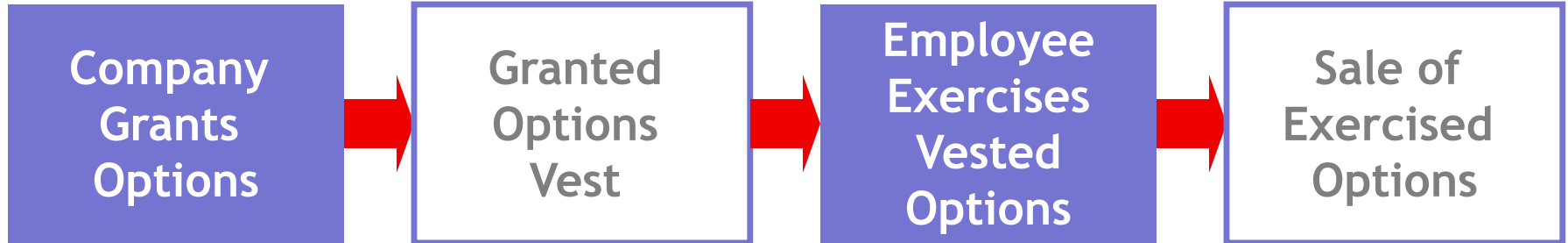
- Example of a vesting schedule:

Years	1	2	3	4
% Vesting	25%	25%	25%	25%

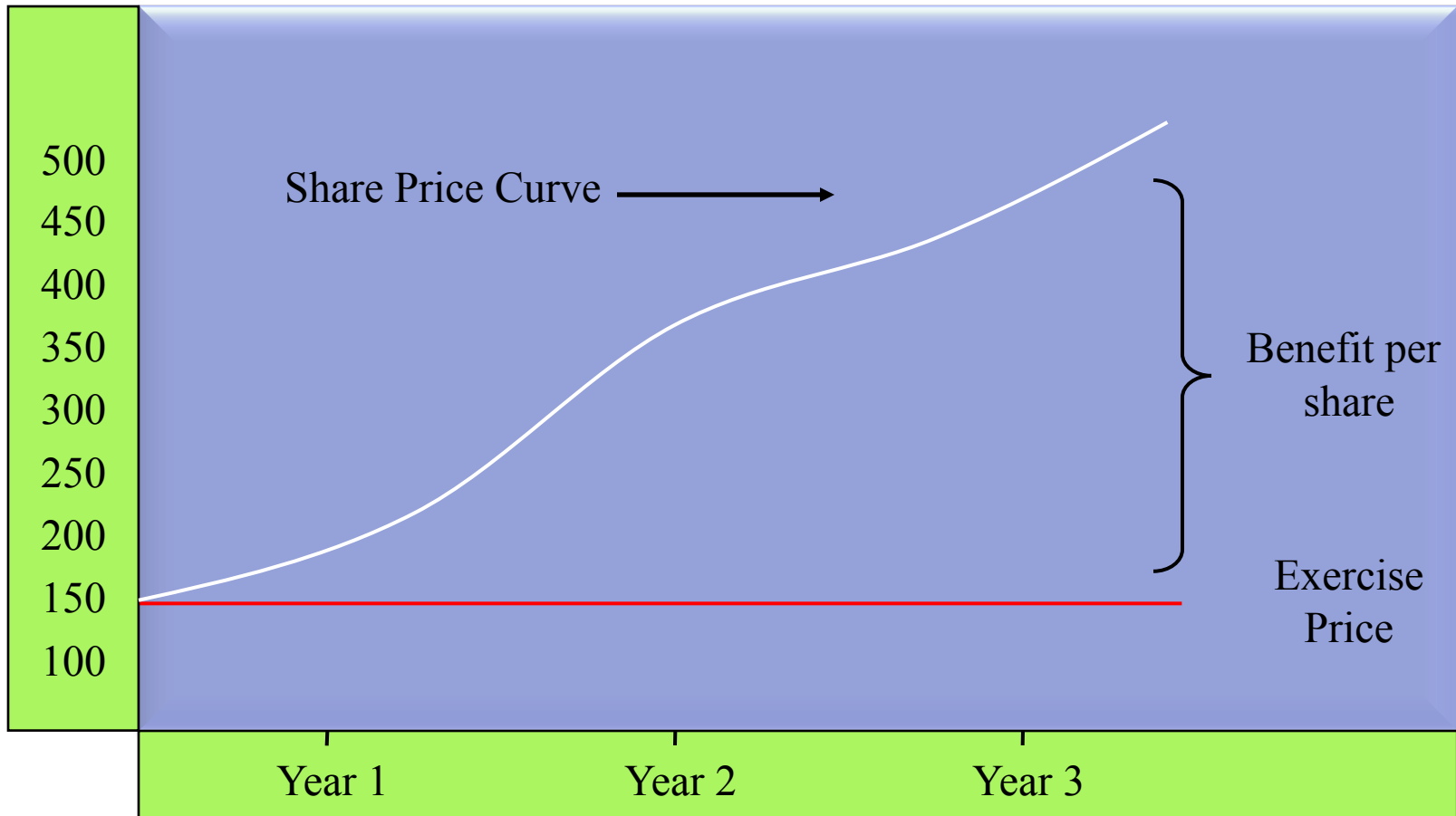
	2026	2027	2028	2029	2030
Options Granted	200				
Vesting of Options		50	50	50	50



ESOP Lifecycle



How does Employee Benefits



Types of ESOPs

ESOP

- Employee Stock Option Plan

ESPP

- Employee Share Purchase Plan

SAR

- Stock Appreciation Rights

Phantom

- Phantom Option

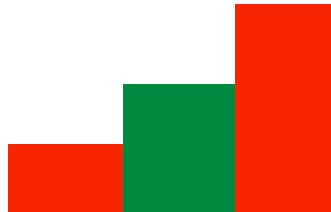
Types of ESOPs



ESOP

- Employee Stock Option Plan

- Options which can be converted into Equity Shares on a future date are granted.
- Conversion of Options in shares happen on completion of the lock in period (vesting period).
- Generally post conversion, there is no lock in period for the equity shares

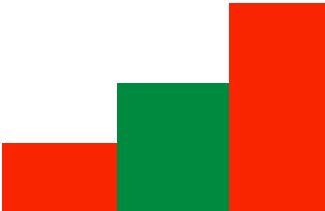


Types of ESOPs



ESPP

- Employee Share Purchase Plan

- Shares are issued at the start of scheme to employees at a certain price.
 - These shares have a lock in period during which employee cannot sale the shares.
 - Employee need to pay for the price on date of issue i.e. on the day the scheme is implemented.
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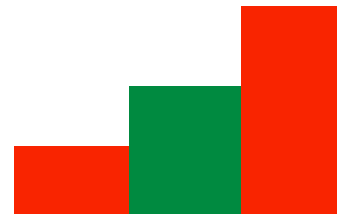
Types of ESOPs



SAR

- Stock Appreciation Rights

- A stock appreciation right (SAR) is a form of bonus compensation given to employees that is equal to the appreciation of company share price over an established time period.
- These increase in share price is paid to employee in cash.
- Employee is not required to pay exercise price nor can he become shareholder of the company at any point of time in future.



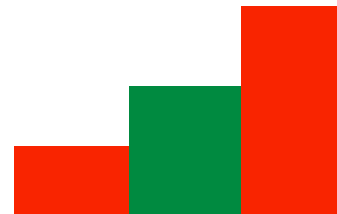
Types of ESOPs



Phantom

- Phantom Options

- A Phantom Option is a form of SAR where appreciation of company share price over an established time period is paid in form of free shares to the employees.
- Employee is not required to pay exercise price.

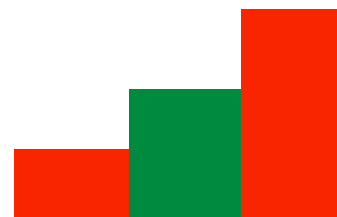


Implementation Modes

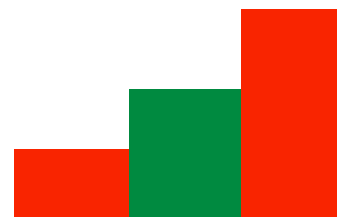
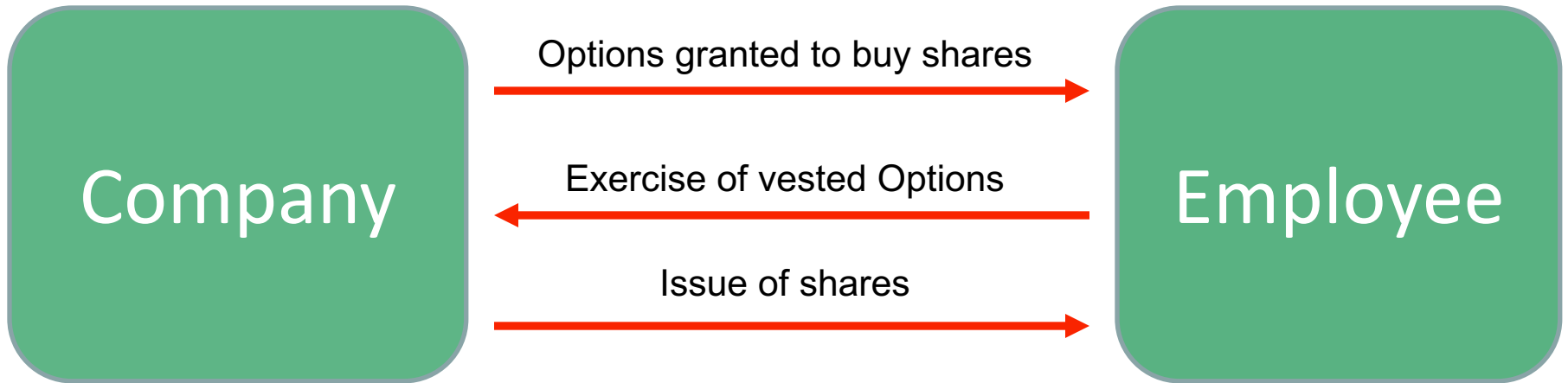


Direct Route

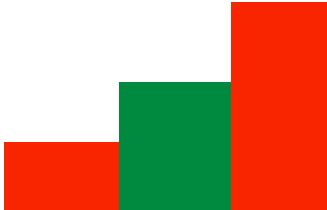
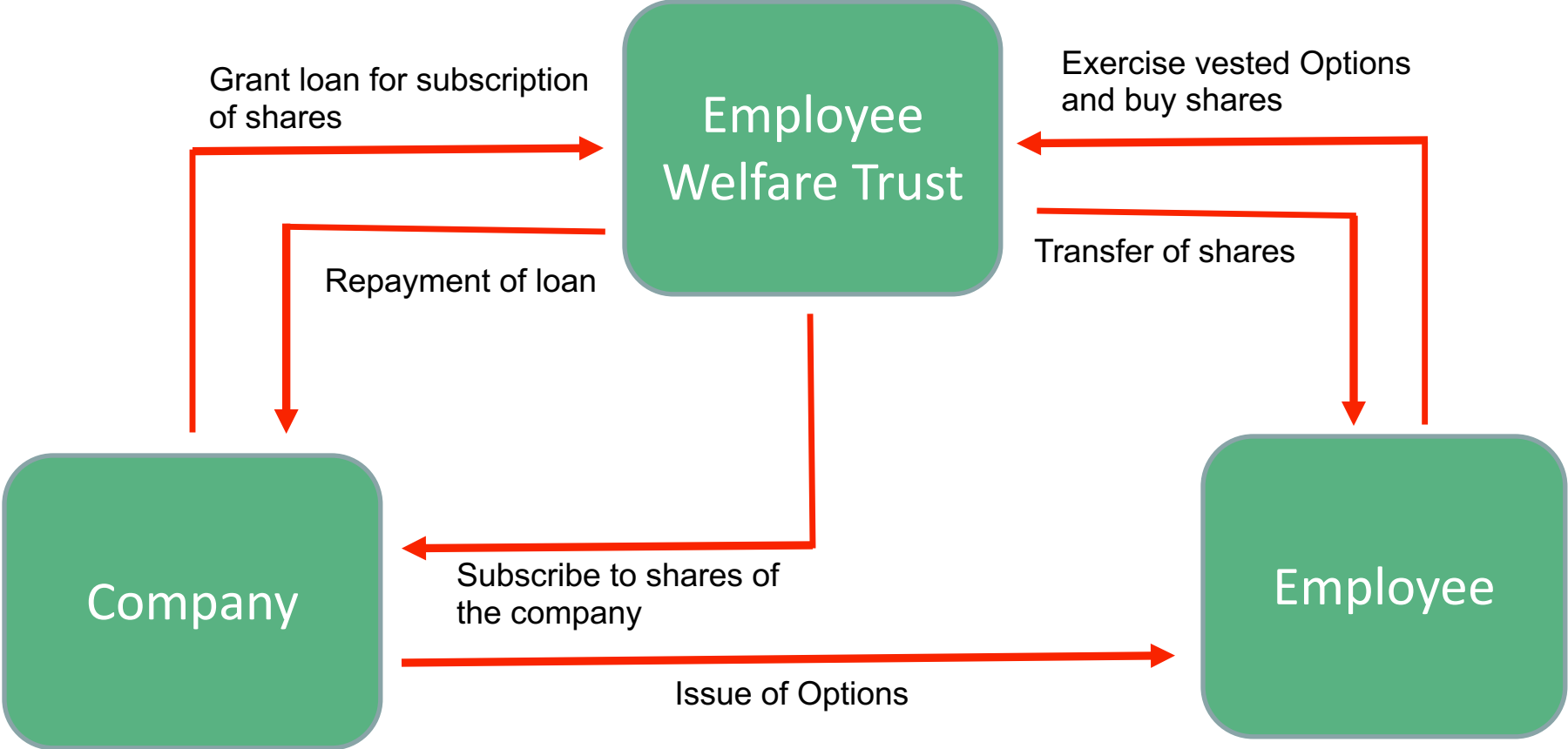
Trust Route



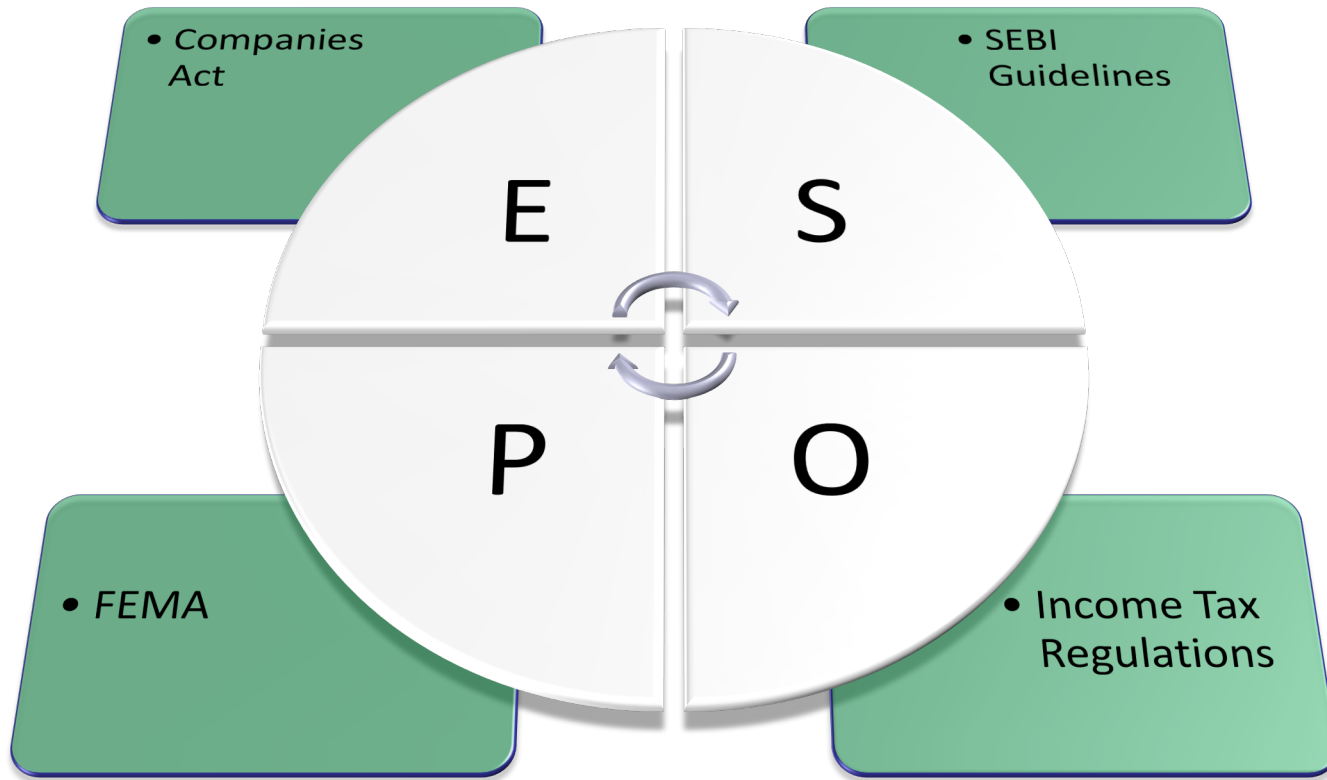
Direct Route



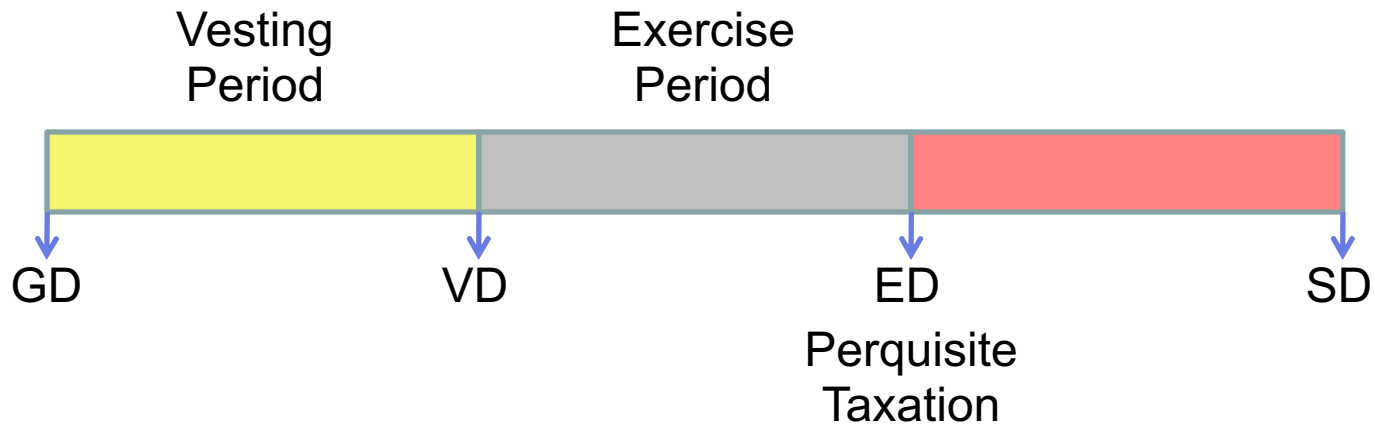
Trust Route



Applicable Rules & Regulations



ESOP Taxation



- On Exercise

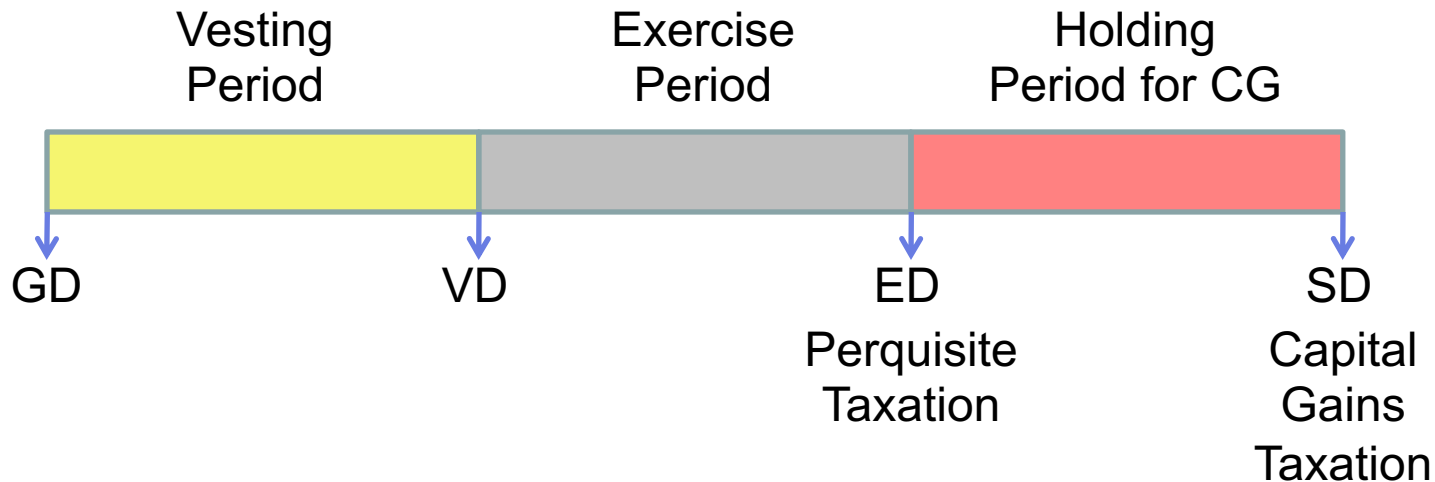
Difference between the **prevailing price** and **exercise price** taxed as perquisite

Eg: Price as on date of exercise	Rs.500
Exercise Price per Option	Rs.150
No of Options exercised	1000

Perquisite = $(500 - 150) \times 1000 = \text{Rs.}350,000/-$

TDS shall be done as per applicable slab rate.

ESOP Taxation



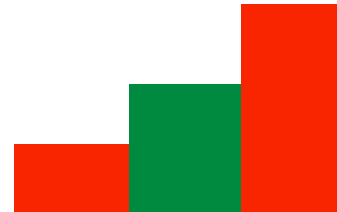
- On sale of shares
Difference between **selling price** and **price as on date of exercise** taxable as Capital Gains

Eg: Price as on date of exercise Rs.500
Selling price per share Rs.700
No of shares sold 1000

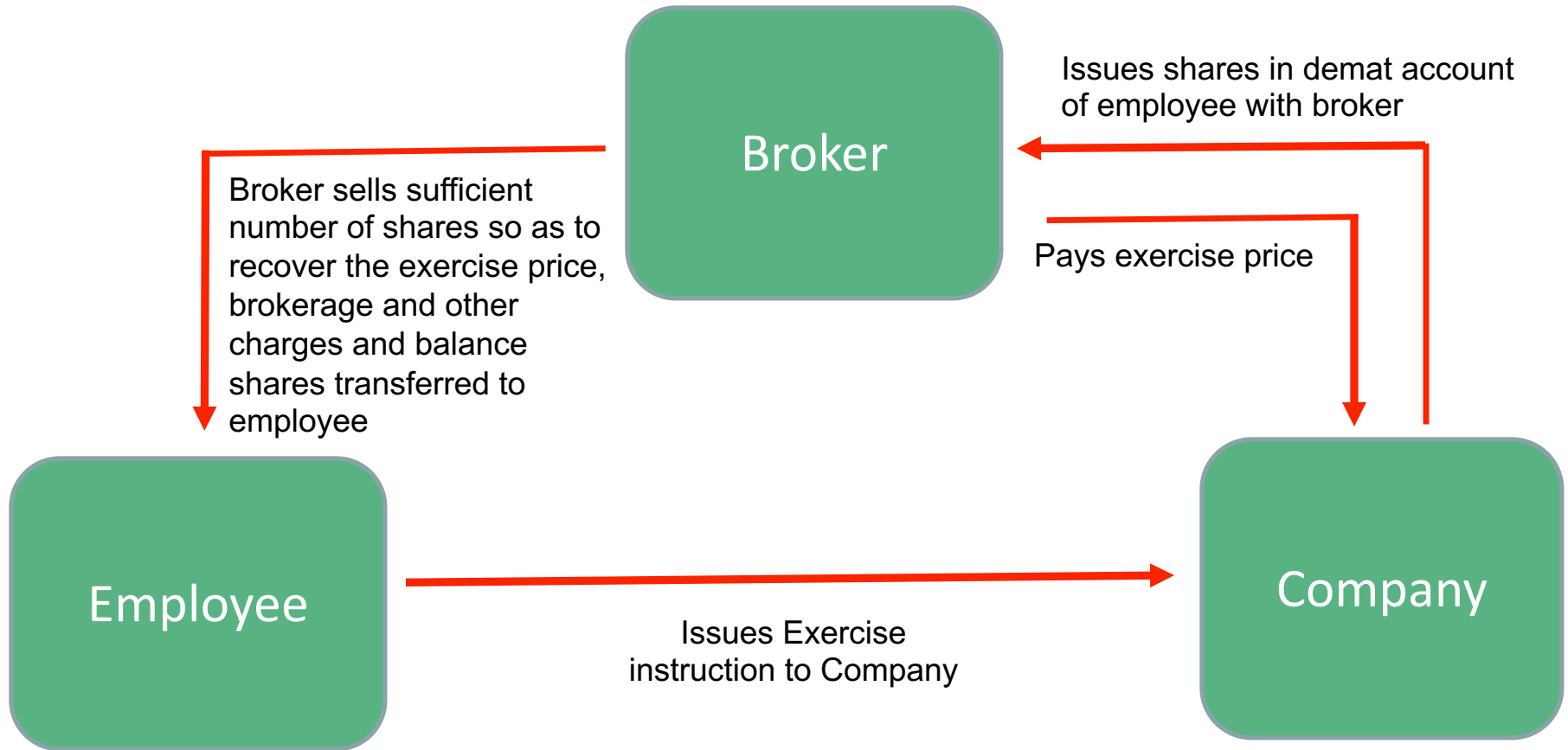
$$\text{Capital Gains} = (700 - 500) \times 1000 = \text{Rs.200,000/-}$$

ESOP Taxation

- In case of eligible startup as referred to in section 80 IAC (1961 Act) / section 140 (2025 Act), TDS to be done within 14 days from:
 - on expiry of 48 months from the end of Tax Year in which the Options are exercised;
 - on date of cessation of employment;
 - from the date of sale of securities allotted under ESOP (*whichever is earlier of above*)



Cashless Exercise Procedure



ESOP Accounting

Accounting Method

GN issued by ICAI

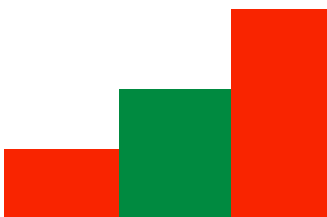
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Intrinsic Value Method or
Fair Value Method

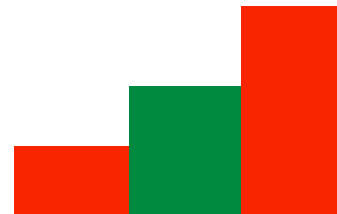
Option Value = Value calculated
using any binomial model eg:
Black Scholes Method

- Aggregate Option Value to be amortised over the vesting period on SLM.

Intrinsic Value Method

- Market price as on the date of grant – Rs.100/-
 - Exercise price per Option – Rs.25/-
 - Number of Options Granted – 1000
 - Vesting period – 100% after 3 years
 - Date of Grant – 1st April 2013
-
- Intrinsic Value = $100 - 25 = 75$ per Option
 - Aggregate ESOP Cost = $1000 \times 75 = 75,000$
 - ESOP cost to be debited to P&L
 - In 2013-14: $(75000 / 1095 \text{ days}) \times 365 \text{ days} = 25000$
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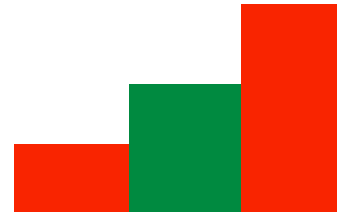
Accounting in case of Graded Vesting



Accounting in case of Graded Vesting

- Vesting period – 25% at the end of every 12 months (i.e. equal vesting over 4 years)
- Details of vesting of Options:
 1. 25 Options vest at the end of 1 year from date of grant.
 2. 25 Options vest at the end of 2 years from date of grant.
 3. 25 Options vest at the end of 3 years from date of grant.
 4. 25 Options vest at the end of 4 years from date of grant.

Treat each vesting as a separate grant and calculate the accounting impact.



Accounting in case of Graded Vesting

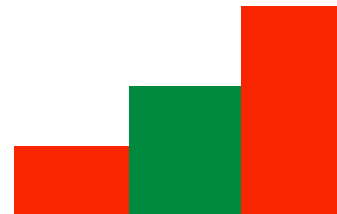
- New Example:

1. 25 Options granted on 1/4/26 which vesting 100% after 1 year.
2. 25 Options granted on 1/4/26 which vesting 100% after 2 years.
3. 25 Options granted on 1/4/26 which vesting 100% after 3 years.
4. 25 Options granted on 1/4/26 which vesting 100% after 4 years.

- Previous Example:

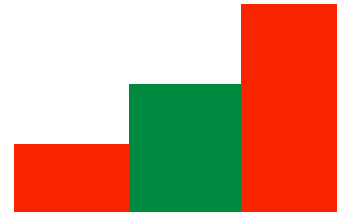
100 Options granted with 25% vesting at end of every 12 months (i.e. equal vesting over 4 years)

Treat each vesting as a separate grant and calculate the accounting impact.



Fair Value of Option

- Fair value of Options to be calculated using any binomial valuation method which takes into consideration the following:
 - Fair market price of share as on the date of grant
 - Exercise price
 - Volatility in share price
 - Expected Life
 - Risk free interest rate
 - Dividend yield
- Generally Black Scholes model is used for arriving at Fair Value of the Option.



MCQ

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.



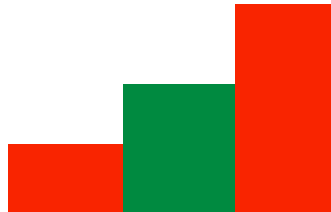
MCQ

Q2. If securities allotted under ESOPs are subsequently transferred by the employee, the gains arising there from 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 there from shall be taxable under the head 'Capital Gains'.



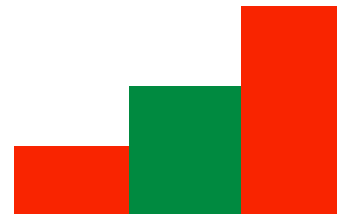
MCQ

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.



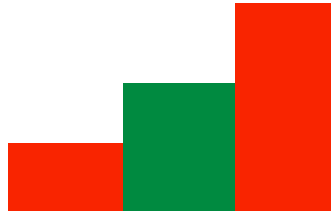
MCQ

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.



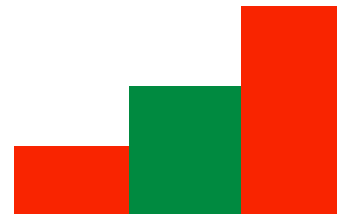
MCQ

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.



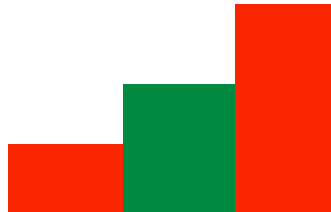
MCQ

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.

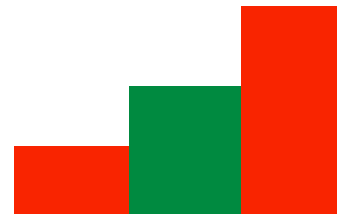


MCQ

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)

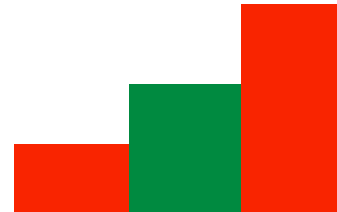
Correct Answer: (d)



MCQ

Justification for correct answer: Section 192 (1961 Act), 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.



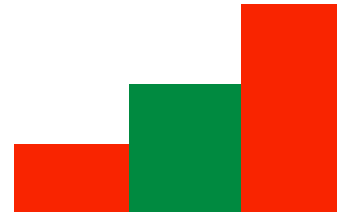
MCQ

Q8. For the purpose of deduction of tax under section 192 (1961 Act) 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.



Questions

