ESOP Trust Series 2 / 3

ESOP Trust – Nature, Constitution, Operations, Etc.

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ESOP Trust Series 1 / 3 highlights the origination of law that allows dealing and transacting by a company with its own equity shares along with the use cases.

Supposing a company has a use case, the question is what exactly an ESOP Trust is in terms of nature, constitution, documentation, operation, etc.

Knowing these aspects is important as only the specific/ relevant laws or judicial precedents shall be applicable in case of need in future (whether for defence or prosecution or for prefect compliance). *For example, a public/ charitable trust taxation cannot be applied on an ESOP Trust being a private trust by nature.*

Law/ Regulation

Principal rules/ regulations/ laws that govern the constitution, operation and liquidation are:

(a) For ESOP Trust of all or any company: The Indian Trusts Act, General laws of India including the Indian Contract Act, Companies Act, Companies Rules and the Income-tax Act.
(b) For ESOP Trust of a listed company: In addition to above, the SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021

Nature/ type

Busting the myth with some readers, it can be clarified that it is a private trust. It is still a private trust by nature even though constituted by a Public Sector Undertaking.

Further, it can be a revocable or irrevocable trust. For a listed company, it must be an irrevocable trust.

Further, it can be determinate or indeterminate. This is planned depending on the ESOP Plan structuring and tax saving.

Constitution

Irrespective of the nature, it is constituted essentially by three parties:

(a) Settlor: The company which implements the ESOP Plan settles (or creates) the ESOP Trust. The creator company is known as Settlor.

(b) Trustee(s): The Settlor appoints one or more persons as trustees ("**Trustees**") of the ESOP Trust to administer the trust.

The minimum number trustees in case of natural individuals is two and in case of corporate entity is one. There is no maximum specified.

In case of a public (including a listed) company, a person (i) being a promoter, KMP of the company or any of its group company including their relative, or (ii) beneficially holding 10% or more of equity or voting is disqualified.

(c) Beneficiaries: The eligible employees who have an outstanding grant.

Registration

It is not mandatory for an ESOP Trust (unless that holds immovable property). A choice is made depending on different situations including the requirement of local law of the Indian State where the principal office of the ESOP Trust is situated.

Documentation/ books/ register

The constitution is evidenced by a trust deed ("**Trust Deed**"). In case of a listed company, the Trust Deed must have prescribed minimum content.

The trust set-up including its constitution is approved by the Board of Directors of the ESOP implementing company with appropriate board resolution.

Documentation formalities include, consent of the trustee(s), filings with stock exchange in case of listed companies, getting a PAN/ TAN, opening of a bank/ demat/ trading account, etc.

In case of any change (e.g. change of trustees, operational provisions, etc), the Trust Deed is either amended or a supplemental deed is executed,

As an entity, such trust is required to keep books of account and minutes book; basis which the financials are prepared. Periodicity of financials (like quarterly or annual) is dependent consolidation requirement with the Settlor company. The financials may be subject to audit; ultimately ending in filing of income tax return.

Permitted activities

The activities generally permitted are:

a) Any activity of employee welfare if authorised by the settlor company;
b) Dealings in equity shares of its settlor as per ESOP Plan; and
c) Power to manage finance – like taking loan, investing excess funds, etc. but subject to mention in the Trust Deed.

It's dealing in the settlor company's equity shares must be carefully planned (not only in the Trust Deed but also in the ESOP Plan); lest, there could be grave non-compliance of breaking the foundation of the Companies Act, 2013 (*instance 1 narrated below*).

Prohibited activities

Activities, neither allowed under law nor mentioned in the Trust Deed are forbidden.

Instance 1, an ESOP Trust doing a swing trade in settlor's equity shares on the reason it could gain something for utilization for employee welfare. It's a breach of the Companies Act – it has no or difficult cure.

Instance 2, an ESOP Trust using excess funds for employees' education/ meals without authority of the Settlor or without specification in the Trust Deed. It's a curable with appropriate ratification.

Financial needs

For executing permitted activities, an ESOP Trust needs money. Legally there is no bar taking money by way of donation, raising a loan or any other permitted ways of raising funding.

In case of a public (including a listed) company, the applicable laws require any loan, or provision of guarantee or security w.r.t. a loan by the settlor company should be approved by way of a special resolution of the shareholders. Further, there is a limit of such financial assistance up to 5% of the Paid-up capital and free reserves.

This 5% ceiling may not apply in case the settlor company is not involved in anyway with the loan.

Main Operations

Out of many stages of ESOPs (viz Grant, Vesting, Exercise, & Sale of shares), the ESOP Trust invariably takes care of Exercise as under:

a) Acquire, hold and transact in equity shares for the purposes of the ESOP Pla;
b) Receive and process of exercise applications from the employees;
c) Process exercise price and taxes received from employees, or full / partial cashless exercise (as allowed); and
d) Transfer shares to employee's demat or remit money to employee's bank (depending on type of exercise specified above).

In additional to above, the Grant and Vesting related administration can also be entrusted to the ESOP Trust with appropriate ESOP structuring.

Liquidation/ dissolution

A day may come, when the trust objective stands fulfilled, or say the assets/ shares owned by the ESOP Trust is destroyed (due to insolvency of settlor company or for any other reason), then such trust may be processed for liquidation.

This requires appropriate resolution at the settlor company's end with execution of deed of liquidation or extinction of ESOP Trust. Any residual asset (net of liabilities) are generally distributed to the last surviving beneficiaries, used by another employee welfare trust or may be transferred to the company, depending on (i) the (listed/ unlisted) status of the settlor company, or (ii) nature of the trust being revocable or irrevocable, determinate or indeterminate.

The key to have an effective ESOP Trust lies in assessing the ESOP objectives being met through appropriate simulation of all transactions involved along with the consequences. The simulations that give favourable (legal, accounting, tax and easy administration) consequences are finalised and documented.

The last series (3 / 3) envisages our understanding on few critical aspects vital for effectively using the ESOP Trust route.

ESOP Trust has many nuances (as to its origin, use cases, nature, constitution, documentation, registration, financial needs, permitted activities, forbidden activities, dissolution, taxation, and other aspects) depending upon listed or unlisted status of the implementing company. Key nuances are dealt with in the ESOP Trust Series 1,2 & 3.