



ESOP TRUST

ESOP Trust Series 3 / 3

ESOP Trust – Governance, Taxation, 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.

ESOP Trust Series 2 / 3 highlights the basic applicable laws, nature/ type, constitution documentation, operation and permitted/ prohibited activities.

This Series endeavours to highlight other aspects (like governance, taxation, etc.) by way of discussing few real-life ESOP Trust cases basis our understanding of law and practice.

Governance aspects

When solution to an issue may not be found expressly written in any law, the role of Governance is said to start that moment or governance is something in addition to any written law.

Its is not limited to appropriate book keeping, auditing or filing correct tax returns on time. It may encompass how truly a trust (a faith or belief) is restored in all its key stakeholders namely the Settlor, the Beneficiaries and the Regulator. For example, while choosing one of two legally approved ways of executing a transaction, making a choice mindfully that satisfies every stakeholder.

Its relevant to check a Trustee's role in SEBI's Prohibition of Insider Trading Regulations ("PIT Regulations") context.

Insider Trading Aspects

The ESOP Trust is an Insider as PIT Regulations. Thus, any dealing (acquisition and disposal) in equity shares of its listed settlor is subject to such restrictions, limitations, approvals, and disclosures as prescribed.

Sometimes, spirit of PIT Regulations is followed as a governance measure, when letters fall short. *For instance, in a known day of high fluctuation (say, day of Union budget, declared surgical strikes, etc.), dealing in shares in the open market should be avoided (unless such dealing is pre-scheduled), or that there must be a planning as to acquire or dispose of in such quantum or with such pricing that should avoid any price rigging.*

Choosing Trustees

As an ESOP Trust envisages and passes through several roles and stages, companies weigh appointing a (i) professional or a professional entity having all round knowledge of law, accountancy, taxation, company law governance, compliance, court/ regulatory procedures, stock market, vis-à-vis, (ii) its own employees (not being Promoters, KMPs or their relatives, etc.). In case of an eventual compliance lapse/ issue, a company gets so much of defence as the Trustees' have expertise in aforesaid fields.

This defence can also be built by appointing a professional advisor to the ESOP Trust in case for unavoidable reasons the company appoints its own employees. This may be a case of risk aversion or bringing governance expertise.

Taxation consequences

An ESOP Trust is seen as an integrated part of the ESOP ecosystem of the implementing company. Thus, there may be questions as to its taxation in relation to various roles it performs in the ESOP ecosystem and various ESOP stages. Please note that this compilation focuses on taxation of ESOP Trust and there is no mention of employee or company taxation.

ESOP Trust is taxed as an association of persons or body of individuals and accordingly tax rates apply.

Role/ activities	Transactions/ Tax consequences on the ESOP Trust
a) Acquisition of shares	i. <u>Subscription of primary shares</u> : No tax ii. <u>Purchase of secondary shares or receipt of shares as gift</u> : Tax consequence is tested under the head income from other sources
b) Grant of ESOPs	Shares do not move; thus, have no tax consequence.
c) Vesting of ESOPs	Shares do not move; thus, have no tax consequence.
d) Exercise of ESOPs	i. <u>Shares transferred to employees upon exercise or sold upon cashless exercise</u> : the excess of exercise price over cost of acquisition is taxable under the head capital gains ii. <u>Sold in open market upon cashless exercise</u> : If trust (as an agent) sells with appropriate legal documentation showing sale by and on behalf the employees (as master), any further capital gain beyond (d)(i) above is not taxed. <i>[When the trust acquires shares at exercise price or exercise price is fixed at Trust's cost, there is no adverse tax on such Trust and it's possible to make it a perfect conduit. This gives a tax management avenue for structuring Liquidity event(s) in an unlisted company where ESOP shares are sold to an existing/ incoming investor with the help of an ESOP Trust]</i>
e) Disposal of shares (other than due to exercise)	In case, shares are sold by the ESOP Trust (say, for meeting SEBI norm of balancing down secondary shares vis-à-vis outstanding ESOPs), the gain being excess of sale price

	over cost of acquisition is taxed under the head capital gains.
f) Dividend/ interest come	It is taxed at applicable tax rate.
g) TDS responsibility	It is required to administer tax deduction at source (“TDS”) on certain payments it makes to others.
h) Any other income	Say, receipt of gift or donation of money may be taxable under the head Income from Other sources.

Interest free or interest-bearing company loan to an ESOP Trust

This has no straight answer as there is a choice under the Companies Act. However, the choice is generally tested in the context of deemed income tax impact, dividend history, and cashflow impact in the books of both ESOP Trust and the company.

Funding to ESOP Trust in case of group level ESOP implementation

There are situations where a company intends to implement an ESOP Plan through an ESOP Trust route covering eligible employees of its group including its holding company and subsidiaries. The ESOP Trust needs funding for acquiring the underlying shares of ESOPs granted to all employees taken together. There could be a question as to which entity should fund, or all employer entities should fund, or any entity can fund with cross charge of interest. This is essentially solved basis facts of each case basis governance and justification of true and fair view of financials.

Way forward upon M&A of companies

There are instances of merger, demerger, different forms of amalgamations. There could be issues as to what happens to an ESOP Trust upon M&A transaction between/ amongst companies where (i) all having their respective ESOP Trusts, or (ii) few having ESOP Trusts and rest with direct route of ESOP implementation or do not have ESOP Plan at all.

These kinds of issues are solved as per provisions of the Indian Trusts Act read with relevant ESOP governing rules or regulations and accordingly placed in the scheme of arrangement for approval.

Switching over from ESOP Trust to Direct route and vice-versa

A choice of route may prove inappropriate or inefficient later, due to any reason including the reason of change of facts and circumstances, or lack of proper planning/ structuring. There are real instances of unfitting choices of trust or direct route; thus, SEBI has introduced a provision to switch over. Switching from direct to trust may be tricky; whereas the opposite is even more tricky/ technical as the existing ESOP Trust (presumably with some assets net of liability) has to be dissolved.

Trust route is an exclusive privilege given by the Companies Act. Being a privilege, it can be a simple and attractive giving multiple benefits to the stakeholders; provided that all its nuances are known and applied by the company or it's consultant to assess in which form the ESOP Trust should be structured.

Our write-ups on other fine-tuned aspects of ESOPs are available in our website and social media.