



Ascentia
Core Consulting

Employee Stock Purchase Plan



UNDERSTANDING ESOPS

From Concept to Strategic Tool in India

In today's competitive business landscape, retaining and motivating employees is as crucial as acquiring customers or raising capital. Among the various tools to align employee interest with organizational growth, Employee Stock Ownership Plans (ESOPs) have emerged as a powerful and flexible option—especially in India's burgeoning start-up and private enterprise ecosystem.

This article walks you through the essentials of ESOPs—from basic definitions to their role in strategic planning—helping businesses, HR leaders, and finance professionals appreciate both the benefits and practical considerations of implementing them.



What is an ESOP?

An Employee Stock Ownership Plan (ESOP) is a structured program that allows employees to acquire ownership interest in the company they work for. These are not outright grants; instead, ESOPs typically operate through a phased approach:

1. **Grant** – The company grants an option to purchase a specified number of shares at a predetermined price (exercise price).
2. **Vesting** – Over a defined period (commonly 3–5 years), employees earn the right to exercise their options in stages.
3. **Exercise** – Once vested, the employee may choose to “exercise” their options by paying the exercise price to receive actual shares.
4. **Sale** – Eventually, employees can sell these shares (usually upon exit, IPO, or a buyback event), thereby realizing financial gains.

Why Companies Offer ESOPs

Companies use ESOPs not just as a reward mechanism, but as a multifaceted tool serving several strategic objectives:



- **Talent Attraction & Retention:** ESOPs are particularly effective in attracting top talent, especially for start-ups and high-growth ventures that may not offer market-leading salaries initially.
- **Performance Alignment:** Since employees become part-owners, their focus often shifts to long-term value creation rather than short-term tasks.
- **Cash Conservation:** In early stages or during liquidity constraints, companies can use equity compensation as a substitute for cash-based rewards.
- **Succession Planning:** Promoters looking to exit or dilute gradually can use ESOPs to transfer ownership internally while retaining control over the transition process.

ESOP Structures in India

In India, ESOPs are typically implemented under the Companies Act, 2013, and are guided by SEBI regulations (for listed companies) or Board/shareholder approvals (for unlisted ones). The most commonly used plans include:

- **Employee Stock Option Plans (Options)** – The most popular form, allowing employees to purchase shares at a fixed price after vesting.
- **Stock Appreciation Rights (SARs)** – Employees benefit from the appreciation in stock value without owning shares directly.
- **Restricted Stock Units (RSUs)** – Shares are awarded after certain conditions are met (e.g., continued employment, performance targets).

Each structure differs in complexity, accounting treatment, and employee benefit realization.

Significant Tax Benefits in the Indian Context

While ESOPs have great potential, their tax treatment in India must be carefully understood:

For Employers:

- Employers can claim a tax deduction on the cost of ESOPs (fair value accounting) over the vesting period.
- This deduction helps reduce taxable income, thereby creating a deferred but valuable tax shield.

For Employees:

- At the time of exercise, the difference between the fair market value (FMV) and exercise price is taxed as perquisite income (salary).
- When shares are sold, capital gains tax applies on the appreciation beyond the FMV. If held for more than 24 months (in unlisted companies), the gain qualifies for long-term capital gains.

For Recognised Start-ups:

Tax on the perquisite value of ESOPs is deferred for up to 48 months or until exit or resignation, whichever is earlier—offering critical flexibility to both employees and promoters.

ESOPs as a Strategic Growth Level

Beyond rewards and retention, ESOPs can unlock significant business value:

- **Improved Corporate Culture:** Studies show that ESOP-led firms often see higher productivity and lower attrition, as employees act like owners.
- **Exit Planning:** ESOPs can be structured as a part of promoter succession or liquidity strategy, especially in family businesses.
- **Investor Attractiveness:** Many VCs and PE investors favour companies with clear ESOP pools, as they indicate seriousness about long-term team building.

Key Considerations Before Implementing ESOPs

While ESOPs offer immense advantages, thoughtful planning and governance are essential. Here's what companies should keep in mind:

- **Dilution Management:** Offering too many options without understanding the impact on ownership structure can lead to promoter dilution.
- **Transparent Communication:** Employees should be educated about the value, taxation, and liquidity of ESOPs to manage expectations.
- **Liquidity Events:** Unlisted companies need to plan buybacks, secondary sales, or IPOs to give employees an opportunity to realize their gains.
- **Compliance:** Regulatory adherence under the Companies Act, FEMA (in case of foreign holding), and Income Tax Act is crucial.

A Win-Win When Done Right

In India's dynamic corporate environment, ESOPs are no longer reserved for tech unicorns or IPO-bound firms. With rising awareness, regulatory support, and maturing capital markets, even mid-sized private companies and family-run businesses are exploring ESOPs as a strategic imperative.

When designed well and communicated clearly, ESOPs foster a culture of shared success—where employees think and act like owners, and companies build a committed workforce that propels them forward.



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