Defer your tax liability from ESOPs by extending exercise period

For more favourable tax treatment at sale, hold the acquired shares for more than a year

Bindisha Sarang

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Media reports suggest that not just startups but even listed companies belonging to traditional sectors are increasingly using employee stock ownership plans (ESOPs) to reward and retain talent.

Aditya Chopra, managing partner, Victoriam Legalis, said: “ESOPs are typically awarded to employees in senior roles and serve as a lucrative incentive for them.”

Startups continue to use them extensively. Pallav Pradyumn Narang, partner, CNK, said: “Startups are nowadays distributing ESOPs across the board to retain employees.”

Opportunity for wealth creation

If the company performs well, its share price increases. Nihal Bhardwaj, associate, SKV Law Offices, said: “Employees can exercise their stock options by buying the company’s shares at the exercise price, which is usually lower than the current market value.” They can sell them at the current market price, realising a profit.

Suresh Surana, founder, RSM India, said: “ESOPs provide tax benefits by levying capital gains tax. They also enable employees to accumulate a retirement corpus.”

Deferred payoff

ESOPs have their share of disadvantages, too. Narang said: “ESOPs defer part of the remuneration.”

Employees have to wait for some time before they can realise their benefits.

Another disadvantage, according to Narang, is that employees have to pay tax on income earned only on paper.

ESOPs also curtail an employee’s freedom to switch jobs as they come with a vesting period during which employees cannot quit the company.

They can create concentration risk in an employee’s investment portfolio as a large portion of their wealth gets tied to one company.

Employees also face market risk. If the company’s stock price declines and falls below the exercise price, the ESOPs become useless.

Taxation at two stages

ESOPs get taxed twice. Nikhil Varma, managing partner, MVAC Advocates & Consultants, said: “First, they get taxed when the employee uses the ESOPs to acquire company shares. Second, the employee incurs capital gains tax when he sells those shares.”

At issuance: The difference between the value of shares at the time of acquisition (called the fair market value or FMV) and the exercise price (the price that the employee paid for the shares) is taxed as perquisite.

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Varma said: "This can differ for listed and unlisted shares. The employer is responsible for deducting tax at source (TDS) at this point from the employee's salary."

The government has eased the tax burden on ESOPs given to employees of startups.

They don't have to pay tax on perquisite value in the year they exercise their ESOPs.

Archit Gupta, chief executive officer (CEO), Clear, said: "TDS on ESOPs would be delayed until the earliest of the following dates: five years from the date of ESOP grant, when the employee sells the ESOP, or leaves the company."

At sale: When the employee sells the shares acquired through ESOPs, he is subject to capital gains tax. The rate depends on whether the company is listed or unlisted and the holding period (computed from the date of exercise of ESOPs until the date of sale of shares).

Capital gains tax is levied on the difference between the sale price and the FMV on the date of exercise. International tax lawyer Adithya Reddy said: "The capital gains tax rate is 15 per cent if the shares are sold within a year of purchase and 10 per cent if they are sold after a year."

Points to keep in mind

Prateek Goyall, partner, MV Kini, said: "If you incur a short-term capital loss, you can carry it forward to offset against future gains, potentially reducing your tax liability."

Employees can also defer their tax liability arising from ESOPs. Chopra added: "By stretching the exercise period, one can mitigate the outflow of tax against the sale of shares in the market."

How to save tax on Esops

Avail exemption on capital gains (Section 54F)

- If you have capital gains from the sale of ESOPs, invest the proceeds in purchasing or constructing a residential house to get an exemption under Section 54F

Invest in tax-saving investments

If your Esop gains are short-term, offset the tax liability by investing in tax-saving options:

- Avail deductions under Section 80C by investing in Equity-Linked Savings Scheme (ELSS), five-year tax-saving fixed deposits (which come with lock-in), and life insurance premiums

- Section 80CCC: Premiums of annuity plans are eligible for deduction

- Section 80D: Claim deductions on health insurance premiums for self, family, and parents

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