Employee Benefits and their Economics

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Coverage

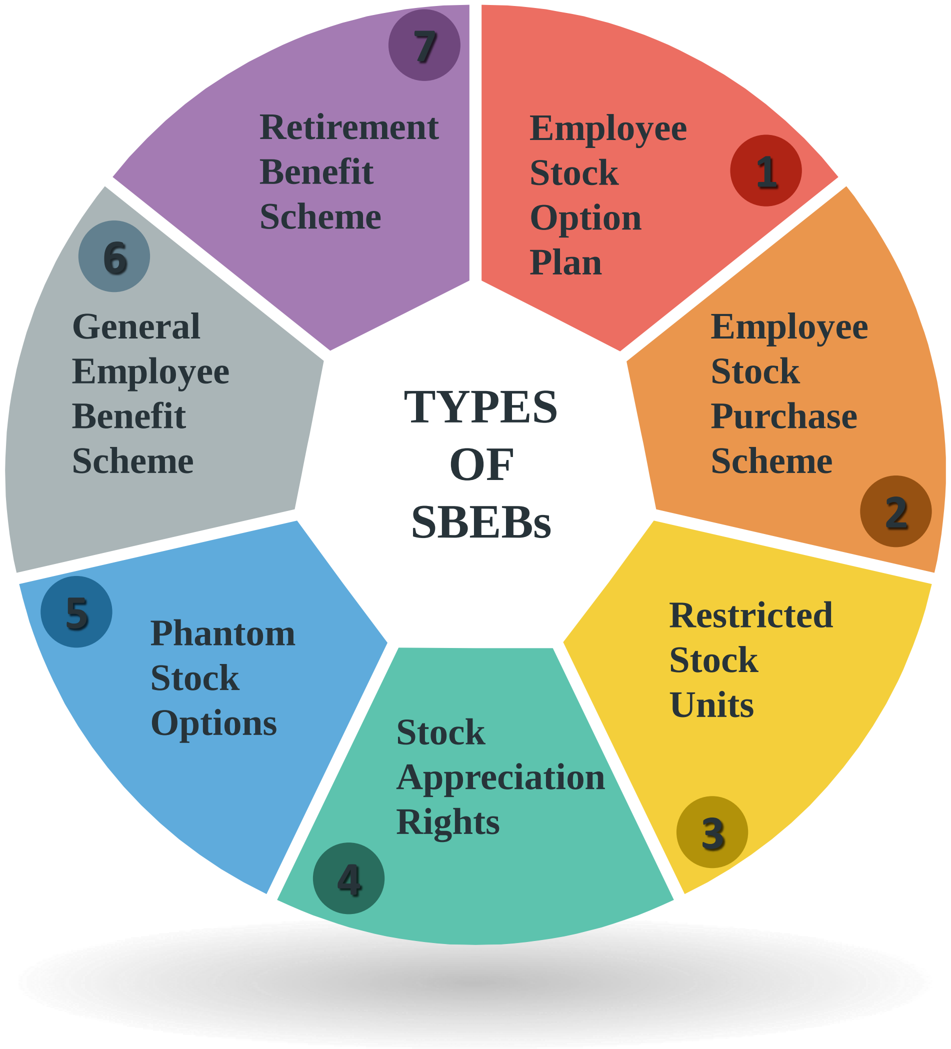
- What are SBEBs?
- Need and reasons for growth of SBEBs
- Major terms
- Types of SBEBs
- Legislative framework

Overview

What are Share Based Employee Benefits (SBEBs)?

- SBEBs are various kinds of benefits in the form of shares or value of shares provided to the employees of the company under an incentive scheme to motivate, reward, remunerate and to retain the employees.

- General benefits:
  - Enable employees to receive a percentage of ownership in the company.
  - Enable companies to free up cash for the company that can be spent in other ways
  - Encourage the employees to remain in the company for longer tenure which resonates the sense of trust amongst them.



Need for SBEBs & reasons for its growing popularity

Need		Reasons for growing popularity	
01	To compensate, motivate and retain employees	01	Effective tool to compensate employees
02	For sustained growth	02	Lucrative to retain employees
03	For risk responsibility and deferred compensation	03	Lesser cash outflow for the Company
04	To align goals of the company and employee	04	Rising stock prices

Major terms (1/2)

Employee

Companies Act, 2013

Rule 12 of SHA Rules
Includes
- permanent employee of the co who has been working in India or outside India
- director of the company, whether WTD or not but excluding IDs;
- employee of a subsidiary, in India or outside India, or of holding co of the co.

Excludes*
- an employee who is a promoter or person belonging to promoter group; or
- director or through relative or any body corporate, directly or indirectly, holds more than 10% of the outstanding equity shares of the company.

**NA in case of startups up to 10 years from date of its incorporation or registration – similar exemption in case of listed entitles has not been provided.*

SEBI (SBEB and Sweat Equity) Regulations, 2021

In case of SBEB - regulation 2(h)
Includes
- permanent employee as designated by of the co, who is exclusively working in India or outside India
- director of the co, whether WTD or not, including a NEDs other than promoter or member of promoter group, but excluding IDs
- employee of a group company/ subsidiary/ associate company, in India or outside India, or of holding co of the co.

Excludes
- employee who is a promoter or person belonging to the promoter group; or
- director or through relative or any body corporate, directly or indirectly, holds more than 10% of the outstanding equity shares of the co.

SEBI (SBEB and Sweat Equity) Regulations, 2021

In case of sweat equity - regulation 29
Includes
- employee of the co working in India or abroad; or
- director of the co whether a whole time director or not.

Major terms(2/2)

Grant

- Process through which company issues benefits
- Employee is offered the options/rights

Grant period

- Date on which compensation committee approves the grant
- For accounting purpose – date as per accounting standards

Vesting

- Process by which the employee becomes entitled
- To receive benefits of grant made to him/her under the scheme

Vesting period

- Period during which the vesting of option, SAR or a benefit granted under any of the scheme takes place

Exercise

- Application by employee for issue of share or cash
- Against option/SAR vested in employee

Exercise period

- Period after vesting period
- Within which employees can exercise the right vested upon them

Exercise price

- Price, if any, payable by an employee
- At the time of exercise of his/her rights, so vested upon them

Lock-in

- Period, if any, during which the shares received pursuant to exercise can't be sold by the employee

Types of employee benefits and their economics

Employee Stock Option Plan (ESOP)

- ESOP refers to
  - a right, but not an obligation,
  - granted to eligible employees
  - to purchase or subscribe to a specified number of shares of the company
  - at a fixed pre-determined price i.e. the exercise price
  - on a future date.
- Employee can exercise his option after the minimum vesting period
- The exercise price remains fixed even if the market price goes up in future.

Economics for the employer

- No tax implication
- Specially advantageous for startups
- Deferred compensation
- Can structure controlled vesting
- No cash outlay
- Leads to dilution of share capital
- Liquidity is impacted (in case of trust route)

Economics for the employee

- Acquire shares at lucrative exercise price
- Share in ownership of the company
- Higher yield of return in case of bullish market, but exposed to risk in case of bearish markets
- Taxed on two instances i.e. in case of allotment and sale

Grant of options → Vesting of options → Exercise of vested options → Allotment of shares → Sale of shares by employee

Restricted Stock Units (RSU)

- RSUs refer to
  - the right given to employees to receive shares or equivalent cash compensation
  - on a pre-determined date
  - subject to occurrence of a specified event or fulfillment of specified conditions.
- Examples of specified events - employee or company's performance, years of employment, specific milestones, etc.
- Usually employee has to pay only face value of shares
- Can be vested gradually or at once.
- They have no tangible value until vesting is complete.

Economics for the employer

- Encourages an employee to remain as part of the company for a prolonged period.
- More predictability with regard to dilution of its share structure
- Based on certain performance levels
- No tax implication
- As units are offered at discount to fair value, impacts profit.

Economics for the employee

- Required to pay lower price as units are issued at discount to fair value.
- Ensured minimum benefit/return
- No mandatory post allotment lock-in
- Lapses in case of exit or not meeting performance condition
- Larger amount of perquisite outflow as compared to ESOPs at fair value

Grant of options → Vesting of options → Exercise of vested options → Allotment of shares

On fulfillment of underlying conditions

Employee Stock Purchase Scheme (ESPS)

- In ESPS
  - an employee has an option to purchase the shares of the company
  - at a certain discounted price on the date of scheme
  - as a part of public issue or through a trust (may undertake secondary acquisition) or otherwise
- No conditions are laid down for purchase
- However, there are restrictions on the sale of the securities

Economics for the employer

- Allot shares at discount to current fair value.
- No cash outlay
- Lower expense as compared to other schemes as shares are allotted upfront. In certain cases, the same are purchased basis employee contribution

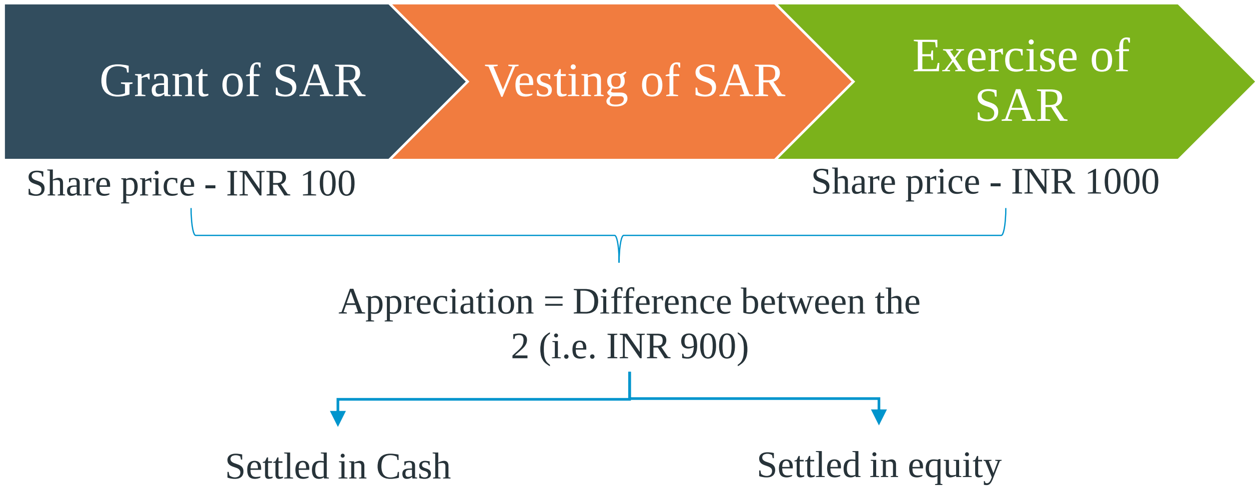
Economics for the employee

- Lower perquisite tax outflow as shares are allotted upfront.
- Schemes permits deduction of amounts for a certain period and then use the same for purchase of shares at pre-determined installment.
- Lock-in period
- No protection in case of fall in prices, as shares already allotted

Offer of shares at discounted price → **On acceptance by employee** → Allotment of shares

Stock Appreciation Rights (SAR)

- SARs refer to
  - Rights entitling employees to **receive cash or shares**
  - for an amount equivalent to the excess of market price on exercise date over a stated price
- Appreciation = Difference between exercise value and base value
- Results in two forms of underlying entitlements at the time of exercise of SARs
  - By way of shares referred to as equity settled SARs
  - By way of cash referred to as cash settled SARs



Economics for the employer

- Does not necessarily lead to dilution of share capital
- In case of cash settled SARs – no obligation to issue shares
- Cash settled SARs do not fall under the ambit of SEBI (SBEB and Sweat Equity) Regulations, 2021 and thus there is no compliance burden
- In case of cash settled SARs – cash outflow is high

Economics for the employee

- No mandatory lock-in period
- No cash outlay
- Can be a deterrent in case an employee wants equity stake
- Uncertainty of payment
- In case of cash settled SARs, employee will get no voting or dividend rights

Phantom Stock Options

- Phantom Stocks Options also known as Shadow Stocks Options
  - Is a performance-based incentive plan
  - Promises an employees/non-employees the right to receive cash payments after a specific period of time or upon fulfilment of specific criteria
  - Directly linked to the valuation and the appreciated value of the share price of the company
  - Amount of award is tracked in hypothetical units
- Can be of two types:
  - Appreciation only: Only appreciation value i.e. receive the difference price of share at grant - current value
  - Full value: price of share at the time of settlement

Grant → Vesting → Exercise

Share price - INR 100

Share price - INR 1000

Appreciation = Difference between the 2 (i.e. INR 900)

↓

Settled only in Cash

Economics for the employer
- No compliance burden[1]
- Attractive means of compensation as no equity dilution
- Preferable for closely held companies
- Can even be issued by LLPs
- Very flexible in nature
- Higher cash outlay

Economics for the employee
- Not required to pay any amount
- Single point of taxation
- Taxed as ordinary income
- No dividend or voting rights
- Not very attractive to employees seeking to have an equity stake in the Company

[1] As laid down by SEBI in its Informal guidance in the matter of Mindtree Limited

Other Schemes

- **General Employment Benefit Schemes** refer to
  - Schemes dealing in shares of the company or the shares of its listed holding company,
  - for the purpose of employee welfare including
    - healthcare benefits, hospital care or benefits, or benefits in the event of sickness, accident, disability, death or scholarship funds,
    - or such other benefit as specified by such company

- **Retirement Benefit Schemes** refer to
  - Schemes dealing in shares of the company or the shares of its listed holding company,
  - for providing retirement benefits to the employees
  - subject to compliance with existing rules and regulations as applicable under laws relevant to retirement benefits in India;

Sweat Equity Shares

Concept

- Sweat equity shares means
  - equity shares issued to the directors or employees
  - at a discount or for consideration, other than cash
  - for providing their know-how or making IPR or value additions, by whatever name called
- Generally issued in initial stages of business
- To top level employees/executives and can also be issued to directors including independent directors
- Can be issued at discount

Relevant provisions under Sweat Equity

- In case of unlisted entity
  - Section 54 of Companies Act, 2013
  - Rule 8 of SCD Rules
- In case of listed entity
  - SEBI (SBEB and Sweat Equity) Regulations, 2021

Limits on issue of sweat equity

- In a year – shall not exceed
  - 5 crores or
  - 15% of existing paid up equity capital

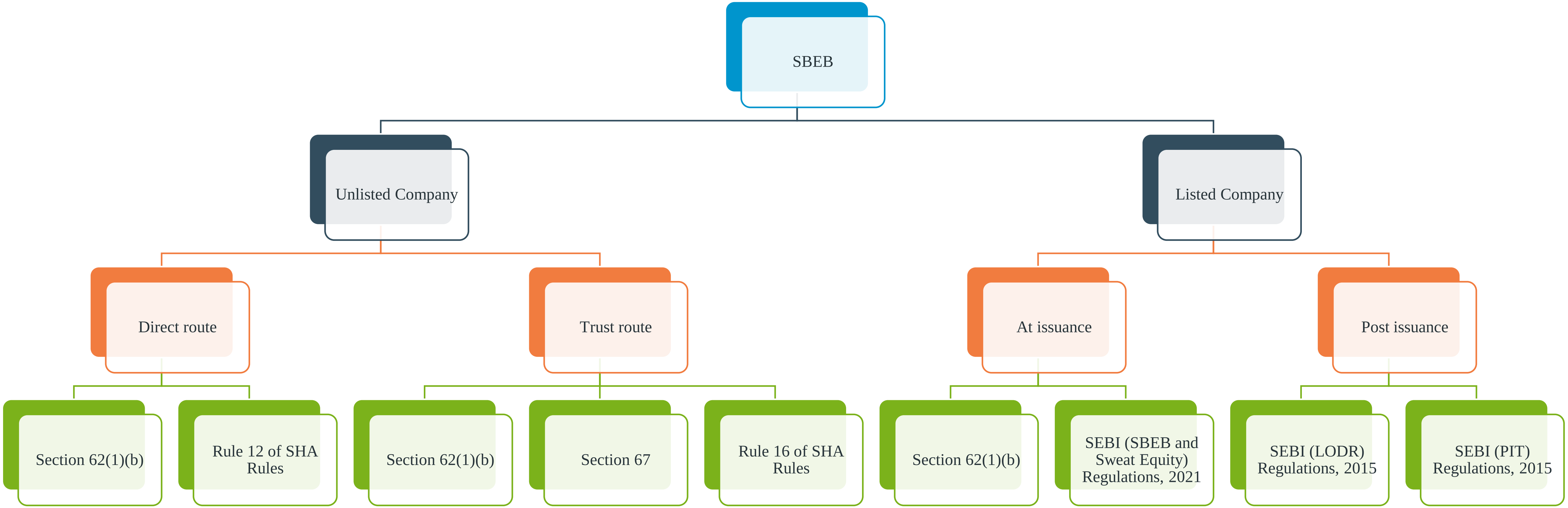
  Whichever is higher
- At any time
  - Shall not exceed 25% of paid up equity capital

Accounting

- Consideration in form of asset
  - shown as asset in Balance Sheet
- In other cases
  - shown as expense in P&L Statement

Legislative Framework

Legislative Framework

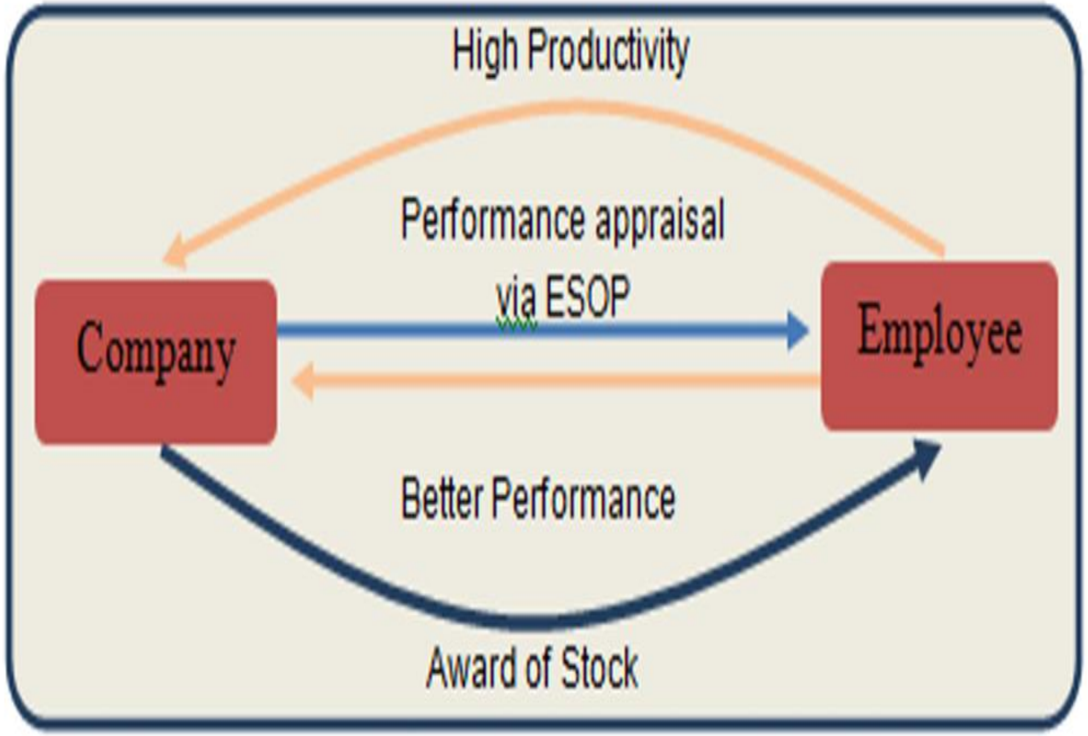


Additionally all companies shall be required to comply with the following:

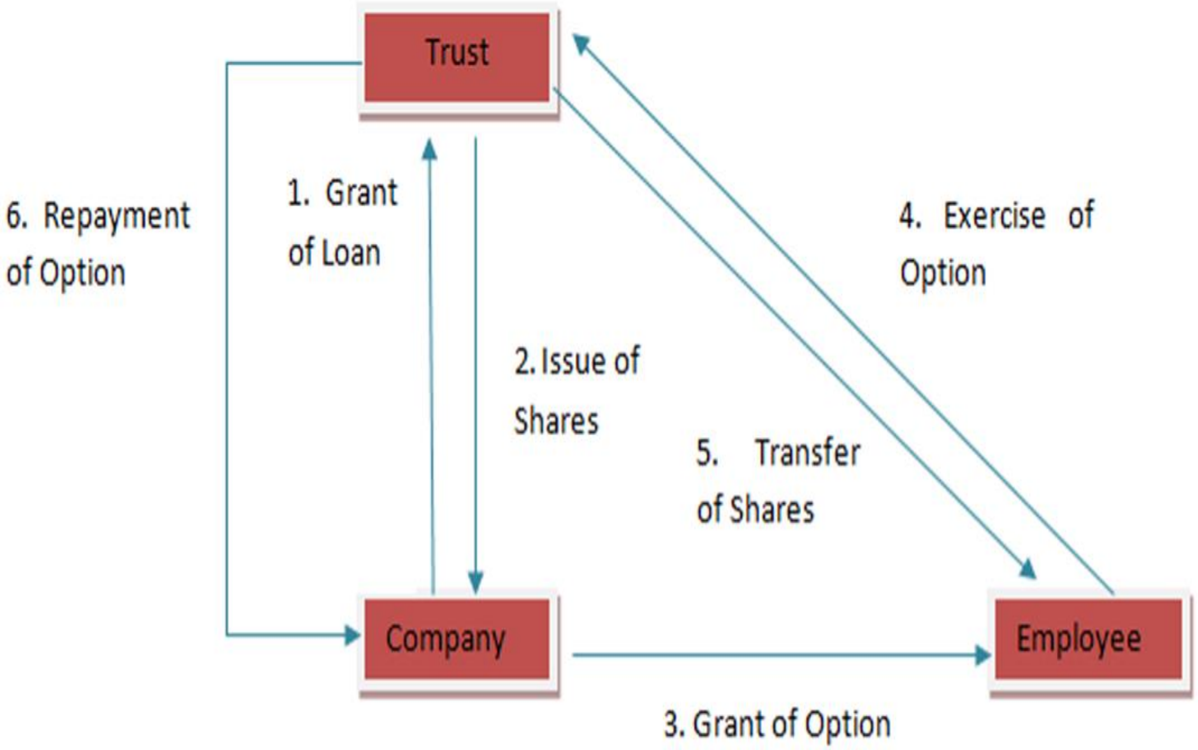
1. Income Tax Act, 1961
2. IND AS – 102/ Guidance note 18, as may be applicable
3. Applicable FEMA Regulations in case of issuances to foreign nationals

Modes of issuance of SBEBs

Direct Route



Trust Route



Source: *[Employee Stock Options: Understanding the regulatory aspects]*

Grant of ESOP by unlisted companies

Prepare ESOP Scheme

Get it approved by NRC and Board

Convene shareholders' meeting to approve the scheme for grant of options

Grant letter of option to eligible employees

Eligible employees to accept the option

Execute ESOP agreement with eligible employees

On expiry of vesting period, employee exercises the option

Allot shares to the employee

Entry in Register of ESOPs in form SH-6

Grant of ESOP by listed companies

1. Board to approve scheme and constitute compensation committee (as per Sec 178 of CA, 2013)
2. Convene shareholders' meeting to approve the scheme
3. Appoint merchant banker for implementing schemes
4. Obtain in-principle approval from SE for listing of shares
5. Committee to frame policies, procedures, terms and conditions of scheme
6. Compensation committee to grant ESOPs to employees
7. If granted to NRI employees, file Form ESOP within 30 days
8. Gap of min. 1 year between grant and vesting. On expiry of vesting period, employee exercises the option
9. Allot shares to the employee

Tax Treatment

- Tax Treatment
  - By employee
    - **At the time of allotment**

      Taxable value (Perquisite) = FMV on date of exercise – Exercise price
    - **At the time of transfer/sale of shares**

      Taxable value (Capital gains) = Sales price of shares – FMV of shares at exercise
  - By employer
    - Shares issued on or after April 1, 2009 under ESOP scheme – No tax liability

      Can also claim compensation to the extent charge to P/L