Start-up employees must pay attention to risk related to stock option plans

Sanjay Kumar Singh Last Updated at February 6, 2020 00:25 IST

Now, they can take the risk of joining without having to pay taxes on Esops immediately.

For quite some time, employees of start-ups have complained about a provision in the income-tax law that caused them hardship. Stock options are taxed in their hands as perquisite at the time of exercising (allotment), creating a liquidity problem for them. In Budget 2020, finance minister Nirmala Sitharaman has announced that the time when start-up employees will have to pay tax on their allotted stocks can be deferred. While their liquidity problems have been taken care of, youngsters joining start-ups need to pay heed to the risks they run when they participate in an employee stock option plan.

Tax liability deferred: ESOPs are currently taxed first at the time of exercise of shares. The difference between their fair market value (FMV) on the date of exercise and the exercise price is taxed as perquisite. The employer deducts tax at source. Esops are also taxed at the time of sale of shares. The employee's capital gain gets taxed, the amount being the difference between the sale price and the FMV (on date of exercise).

Now, for employees of specified start-ups, the payment can be deferred. The tax can now be paid not at the time of allotment, but whenever one of three events occurs first: One, the date the employee leaves the company; two, when the share is sold; or three, after five years from the financial year in which it was exercised. The tax rate that applies will be of the year in which the option was exercised.

At the time of allotment, the employee only gets shares, not hard cash. “Start-up employees faced hardship because while a tax liability arose at the time of allotment of shares, there was no monetary gain for them to pay the tax. The proposed change will help them deal with their cash flow issues,” says Shalini Jain, tax partner, people advisory services, EY India. Employees will also benefit if they have moved into a higher tax bracket. “You will pay tax at the rate that applied to you when the shares were allotted,” says Homi Mistry, partner, Deloitte India.

This benefit will only be provided only to start-ups that meet certain criteria (see box). “Ideally, it should have been provided to a wider range of start-ups,” says Jain.

Next, let us turn to some of risks employees opting for Esops run.

Valuation risk: This is the biggest one. “Employees give up on something tangible—the cash component in their salary—based on the belief in their ability to contribute to the company's growth story. But while opting for Esops, it is impossible to tell which side valuations will tilt," You don’t know how much the valuations will rise,” says Winnie Shekhar, partner, IndusLaw.