

The Ultimate ESOP Guide in India

— GUIDE 2026 —

Companies Act • FEMA • Income Tax • Ind AS 102

A Practitioner's Guide for
Founders, HR Teams,
CFOs & Advisors
in India



BY

SAGAR SHAH

CA | CS | IBBI Registered Valuer | All India Rank Holder | Ex-EY

First Edition | 2026

ABOUT THE AUTHOR

Sagar Shah

CA | CS | IBBI Registered Valuer | All India Rank Holder

Sagar Shah is the Founder of Elite Valuation, an independent valuation and boutique advisory firm serving clients across India. With 15 years of professional experience including 9 years at Ernst & Young (EY), he has designed, valued, and advised on ESOP schemes for companies ranging from early-stage startups to listed corporates.

His ESOP practice covers the full lifecycle: scheme design, tax structuring, Black-Scholes and Binomial valuations, Ind AS 102 and AS 15 compliance, SEBI regulatory filings, and cross-border ESOP structuring for multinational groups with Indian subsidiaries. He advises promoters, CFOs, HR leaders, and ESOP committees on creating equity compensation structures that align employee incentives with shareholder value.

Core ESOP Expertise

- ESOP scheme design - plan architecture, vesting schedules, exercise mechanisms, ESOP trust structuring
- ESOP valuation - Black-Scholes, Binomial, Monte Carlo for performance-based options
- Tax optimisation - structuring for tax-efficient outcomes for both employer and employees
- Ind AS 102 and AS 15 compliance - share-based payment accounting, P&L expense computation
- SEBI compliance for listed companies - Regulations, disclosure requirements
- Cross-border ESOPs - US parent/Indian subsidiary structures, FEMA compliance
- Sweat equity, SAR, and phantom stock plan design and valuation

Phone: +91 7600008550 | **Email:** sagarrvshah@elitevaluation.in

Website: www.EliteValuation.in | **ESOP Advisory:** www.Esopservice.com

ELITE VALUATION - ESOP Advisory & Valuation Practice

Pan-India Services • www.Esopservice.com • www.EliteValuation.in

Our ESOP Services

ESOP Scheme Design: End-to-end plan architecture - eligibility criteria, vesting schedules, exercise windows, ESOP trust vs. direct route, buyback mechanisms.

ESOP Valuation (Grant & Exercise): Black-Scholes, Binomial Tree, and Monte Carlo valuations for grant date (Ind AS 102 / AS 15) and exercise date (Section 17 of the Income Tax Act, 2025) compliance.

Ind AS 102 & AS 15 Compliance: Share-based payment expense computation, modification accounting, cancellation and replacement treatment, quarterly and annual disclosure support.

SEBI Compliance: Listed company ESOP filings, compensation committee advisory, disclosure requirements, scheme amendments, and regulatory submissions.

Cross-Border ESOP Structuring: US parent / Indian subsidiary ESOPs, FEMA recharge and reimbursement structuring, transfer pricing implications, withholding tax advisory.

Sweat Equity, SAR & Phantom Stocks: Alternative equity compensation design, valuation, tax structuring, and regulatory compliance for non-traditional instruments.

“An ESOP is not a benefit - it is a strategic tool. When designed well, it aligns the interests of the people who build the company with the people who own it.”

- Sagar Shah

DISCLAIMER

This guide is for educational and informational purposes only. It does not constitute legal, tax, or financial advice. ESOP implementation requires professional guidance specific to your company's circumstances. Consult a qualified professional before acting on any information in this guide.

© 2026 Elite Valuation. All rights reserved.

TABLE OF CONTENTS

Section 1: ESOP Fundamentals

Chapter 1: Why ESOPs Matter - The Strategic Case for Equity Compensation

Chapter 2: Types of Equity Compensation Instruments

Section 2: Designing the ESOP

Chapter 3: ESOP Scheme Architecture - The Blueprint

Chapter 4: Employee Coverage - Who Gets Options and How Many

Section 3: ESOP Valuation

Chapter 5: Valuation at Grant Date - Black-Scholes and Beyond

Chapter 6: Valuation at Exercise - FMV Determination

Section 4: Taxation

Chapter 7: Tax Treatment for Employees

Chapter 8: Tax Implications for Employers

Section 5: Compliance & Regulatory Framework

Chapter 9: Companies Act, SEBI & FEMA Compliance

Chapter 10: Accounting for Share-Based Payments - Ind AS 102 & Indian GAAP

Section 6: Strategic Considerations

Chapter 11: Employer Playbook - Making ESOPs Work for the Company

Chapter 12: Employee Playbook - Understanding Your ESOP

Conclusion: Working With an ESOP Advisor

SECTION 1: ESOP FUNDAMENTALS

Chapter 1: Why ESOPs Matter - The Strategic Case for Equity Compensation

We are asked a fundamental question in almost every ESOP advisory engagement: “Is an ESOP really worth the complexity?” The answer, almost always, is yes - but only if it is designed thoughtfully.

An Employee Stock Option Plan is not a benefit like health insurance or a bonus. It is a strategic tool that aligns the interests of the people who build the company with the people who own it. When an employee holds options, they think like an owner - they care about profitability, capital allocation, customer retention, and long-term value creation in ways that a salary alone cannot incentivise.

In India’s current market environment, ESOPs have become indispensable for three reasons:

Talent competition: In technology, financial services, and knowledge industries, the best talent has multiple offers. Cash compensation has a ceiling; equity compensation has a multiplier. A well-structured ESOP can turn a Rs.25 Lakh package into a Rs.2 Crore outcome over 4-5 years if the company performs well.

Cash conservation: For startups and growth-stage companies burning cash on product development and market expansion, ESOPs allow competitive compensation without immediate cash outflow. The “cost” is dilution, not cash.

Retention: Vesting schedules create golden handcuffs. An employee who would leave for a 20% salary increase will stay if they have Rs.50 Lakh in unvested options that they would forfeit by leaving.

The Indian ESOP Landscape in 2026

The Indian ESOP ecosystem has matured dramatically over the past five years. Several trends define the current landscape:

ESOP pools are getting larger: Startups are now reserving 10-15% of equity for ESOP pools (up from 5-7% five years ago), reflecting the recognition that equity compensation is essential for talent acquisition.

Listed company ESOPs are under SEBI scrutiny: The SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 have tightened disclosure requirements, compensation committee governance, and scheme administration standards.

Cross-border ESOPs are proliferating: As Indian subsidiaries of US/European multinationals grow, cross-border ESOP structures have become common - with complex FEMA, transfer pricing, and withholding tax implications.

ESOP liquidity is improving: Secondary sale platforms, structured buyback programs, and pre-IPO ESOP monetisation options are giving employees liquidity before a traditional exit event.

Tax and regulatory regime have evolved: The Income Tax Act, 2025 (effective 1 April 2026) replaces the Income Tax Act, 1961, with reorganised sections and updated rules. While the substantive ESOP tax treatment remains largely unchanged, all section references, rule numbers, and form numbers have been updated. Additionally, the DPIIT startup deferral for prerequisite tax continues under the new regime, though the conditions and limitations are frequently misunderstood.

KEY INSIGHT

The biggest mistake we see companies make with ESOPs is treating them as an afterthought - a benefit to be administered by HR, rather than a strategic tool to be designed by the board. The companies that get the most value from their ESOP pools are those where the CEO, CFO, and board actively discuss: How large should the pool be? Who should receive options? What vesting schedule maximises retention? What exercise price structure optimises tax outcomes? These are business strategy questions, not HR administration questions.

Who Should Read This Guide?

This guide is intended for founders and CEOs designing their first ESOP or restructuring an existing one; CFOs and finance teams managing ESOP accounting (Ind AS 102 / AS 15), tax withholding, and financial statement disclosures; HR leaders administering ESOP schemes and communicating with employees; ESOP committee members of listed companies navigating SEBI compliance; employees who hold or have been offered ESOPs and want to understand the financial and tax implications; CAS, CSs, and legal professionals advising clients on ESOP design, valuation, and regulatory compliance; and startup founders using ESOPs as a core part of their talent and compensation strategy.

The Business Case: ESOPs by the Numbers

Consider the financial impact of a well-designed ESOP program. A technology company with 200 employees allocates 10% of equity (valued at Rs.100 Crore) to an ESOP pool. Over 4 years, the total share-based payment expense (under Ind AS 102 or AS 15, as applicable) is approximately Rs.6-8 Crore (after applying forfeitures and the Black-Scholes model). In return, the company achieves: employee attrition reducing from 22% to 14%, saving approximately Rs.3-4 Crore annually in replacement costs; key leadership talent retained through critical growth phases; alignment between employee performance and shareholder value creation; and cash compensation packages structured 15-25% below market, conserving cash for product development and market expansion.

The ROI of a well-designed ESOP is typically 3-5x the share-based payment expense. The ROI of a poorly designed one is negative - expense without retention or alignment benefit.

Common Misconceptions About ESOPs

Before diving into the technical chapters, we address the misconceptions encountered most frequently:

“ESOPs are free for the company”: Wrong. While there is no cash outflow at grant, there is dilution (existing shareholders' percentage reduces), a share-based payment expense on the P&L (under Ind AS 102 or AS 15), and administrative costs. The cost is real - it is just structured differently.

“All employees should get ESOPs”: Not necessarily. ESOPs are most effective when concentrated among employees who directly influence company value. Broad-based programs can work, but they require larger pools and more administration.

“Exercise price should always be face value”: Face value exercise maximises the apparent benefit but also maximises the perquisite tax burden. The optimal exercise price depends on the company's tax strategy, stage, and employee profiles.

“ESOPs are only for startups”: Listed companies, family businesses, and mature companies all use ESOPs effectively - for different purposes (retention, succession planning, performance incentives).

“Once granted, the company’s job is done”: The grant is just the beginning. Ongoing communication, exercise window management, tax advisory, and compliance monitoring are essential for ESOP success.

How to Use This Guide

This guide is structured to take the reader from fundamentals through design, valuation, taxation, compliance, and strategy. Each chapter includes Key Insight boxes with practitioner commentary from real engagements and Pro Tips that can directly improve ESOP programs. Read linearly if new to ESOPs, or jump to the chapter most relevant to a current need.

SECTION 1: ESOP FUNDAMENTALS

Chapter 2: Types of Equity Compensation Instruments

Before diving into ESOP design, it is essential to understand the full menu of equity compensation instruments available under Indian law. Each has different legal requirements, tax treatment, accounting implications, and suitability for different company stages.

Employee Stock Option Plan (ESOP)

The most common equity compensation instrument in India. An ESOP grants employees the right (not obligation) to purchase shares at a predetermined price (the exercise price) after a vesting period. The employee benefits from the difference between the market value at exercise and the exercise price.

Legal framework: Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014. For listed companies, SEBI SBEB&SE Regulations, 2021 apply.

Key features: Minimum vesting period of 1 year (per Companies Act). Exercise period typically 1-5 years post-vesting. Exercise price can be at face value, discount to FMV, or at FMV - with different tax implications for each.

Stock Appreciation Rights (SARs)

SARs give employees the right to receive a payment equal to the appreciation in share value over a reference price, without requiring the employee to actually purchase shares. SARs can be structured in two distinct ways:

Cash-settled SARs: The employee receives a cash payment equal to the appreciation (FMV at settlement minus reference price). No shares are issued, resulting in zero dilution. The entire cash payment is taxed as salary income at the employee's applicable slab rate. From the employer's perspective, the cash outflow is deductible as a business expense under Section 32 of the Income Tax Act, 2025 (corresponding to Section 37(1) of the 1961 Act).

Equity-settled SARs (Share-settled): Instead of cash, the employee receives shares equivalent in value to the appreciation amount. This variant results in dilution (since shares are issued) and triggers a requisite tax event identical to an ESOP exercise. The subsequent sale of shares attracts capital gains tax. From an accounting perspective, equity-settled SARs are treated as equity-settled share-based payments under Ind AS 102 (or AS 15, as applicable), while cash-settled SARs are classified as cash-settled share-based payments with mark-to-market liability recognition.

SARs are particularly useful for companies that do not want to issue additional shares (avoiding dilution, via cash-settled SARs) or for international employees where share issuance creates regulatory complications.

Sweat Equity Shares

Issued under Section 54 of the Companies Act, 2013, sweat equity shares are issued to directors or employees at a discount or for non-cash consideration (intellectual property, value addition). Key requirements include: special resolution, valuation by a Registered Valuer, 3-year lock-in for listed companies, and a ceiling of 25% of paid-up capital (or 15% in a given year).

Phantom Stock Plans

Phantom stocks are notional units that mirror share value but do not involve actual share issuance. On a trigger event (exit, IPO, or time-based maturity), the employee receives a cash payment equal to the value of the phantom units. Key advantages: no dilution, no securities law compliance, and flexibility in plan design. The primary disadvantage is that the employee never becomes an actual shareholder.

PRO TIP

Choosing the right instrument depends on four factors: (1) Do you want employees to become actual shareholders? (If yes: ESOP. If no: SAR or Phantom.) (2) Can the company absorb dilution? (If concerned about dilution: Cash-settled SAR or Phantom.) (3) What is the tax-optimal structure given the company stage and employee tax brackets? We always map these three questions before recommending an instrument.

Comparative Tax Treatment

The tax treatment varies significantly across instruments, which directly affects the after-tax benefit to employees and the cost to the employer. The table below reflects the position under the Income Tax Act, 2025 (effective 1 April 2026). References to the erstwhile 1961 Act sections are provided in parentheses for transitional clarity.

Instrument	Tax at Grant	Tax at Exercise	Tax at Sale	Employer TDS	Settlement
ESOP	None	Perquisite tax (FMV - Exercise Price) as salary [Sec 17]	Capital gains on (Sale Price - FMV at Exercise); LTCG 12.5% / STCG as applicable	Yes, on perquisite	Equity
SAR (Cash-settled)	None	Full appreciation taxed as salary [Sec 15-17]	N/A (Cash-settled)	Yes, on appreciation	Cash
SAR (Equity-settled)	None	Perquisite tax on appreciation (FMV - Reference Price) [Sec 17]	Capital gains on (Sale Price - FMV at Exercise)	Yes, on perquisite	Equity
Sweat Equity	None	FMV taxed as perquisite [Sec 17]	Capital gains on (Sale Price - FMV at allotment)	Yes, on perquisite	Equity
Phantom Stock	None	Full payment taxed as salary at settlement [Sec 15-17]	N/A (Cash-settled)	Yes, at settlement	Cash

Table: Comparative Tax Treatment of Equity Compensation Instruments (Income Tax Act, 2025)

Cash-Settled SAR vs. Phantom Stock - Tax Treatment Distinction

Both cash-settled SARs and phantom stocks are cash-settled instruments with no actual share issuance. While their economic substance is similar, the tax treatment differs in timing and characterisation:

Cash-settled SARs are taxed at the point of exercise or settlement. The appreciation (FMV at settlement minus reference price) is treated as salary income and taxed immediately under the head “Salaries.” TDS is deducted by the employer at this stage.

Phantom stocks are typically structured with deferred settlement tied to a specific trigger event (such as an exit, IPO, or a pre-defined maturity date). No taxable event arises until actual settlement occurs. At settlement, the full cash payment is taxed as salary income. This deferral in the taxable event distinguishes phantom stocks from SARs in practice, even though the eventual tax characterisation (salary income) is the same.

The distinction is therefore one of **timing**, not of tax character. Companies should structure the settlement trigger carefully, as premature settlement of phantom stocks would collapse the timing distinction and render them functionally identical to cash-settled SARs for tax purposes.

Which Instrument for Which Stage?

Based on our advisory experience across multiple ESOP engagements, here is the general guidance by company stage:

Pre-revenue / Seed stage: ESOPs at face value exercise price. Simple structure, maximum upside for early employees who are taking the highest risk.

Series A/B: ESOPs with discounted exercise price (30-50% of FMV). Balances employee benefit with tax efficiency as valuations increase.

Late stage / Pre-IPO: ESOPs are simpler for employees at this stage and avoid the cash outflow of exercising high-priced options.

Listed companies: ESOPs under SEBI framework. Performance-linked vesting conditions tied to stock price or financial metrics.

Companies concerned about dilution: Cash-settled SARs or Phantom Stocks. No share issuance, no dilution, but cash cost at settlement.

Cross-border structures: Parent company ESOPs with Indian subsidiary recharge. Requires FEMA and transfer pricing structuring.

SECTION 2: DESIGNING THE ESOP

Chapter 3: ESOP Scheme Architecture - The Blueprint

Designing an ESOP is not a legal drafting exercise - it is a business strategy exercise with legal, tax, and accounting dimensions. The scheme architecture determines whether the ESOP will attract talent, retain key performers, and create real alignment between employees and shareholders - or whether it will become an administrative burden that generates confusion and resentment.

The ESOP Lifecycle

The complete ESOP lifecycle consists of six stages:

- (1) Design & Approval - Board and shareholder resolution;
- (2) Grant - ESOP Committee grants options;
- (3) Vesting 1-4 years cliff plus graded vesting;
- (4) Exercise - Employee pays exercise price;
- (5) Lock-in / Holding - Minimum 1 year for LTCG benefit;
- (6) Sale / Exit - Liquidity via buyback or IPO.

Step 1: Board and Shareholder Approval

Under the Companies Act, 2013, an ESOP scheme requires:

- (1) Board resolution approving the scheme;
- (2) Special resolution (75% majority) of shareholders;
- (3) For listed companies, approval of the Nomination and Remuneration Committee (NRC) before the board resolution;
- (4) Filing of return of allotment (Form PAS-3) upon exercise.

The special resolution must disclose: total number of options to be granted, identified classes of employees eligible, vesting period, exercise price, exercise period, appraisal process for determining eligibility, and maximum number of options per employee.

Step 2: Pool Size Determination

The ESOP pool size is expressed as a percentage of fully diluted equity. Typical ranges by company stage:

Company Stage	Typical Pool Size	Rationale
Pre-seed / Seed	10-15%	Equity is primary compensation tool; key hires need significant upside
Series A	8-12%	Balance between founder dilution and talent needs
Series B/C	7-10%	Pool refreshed for leadership hires; earlier grants partially vested
Pre-IPO	5-8%	Top-up for retention through IPO lock-in period

Company Stage	Typical Pool Size	Rationale
Listed Company	3-5%	Regulated by SEBI; used for retention and performance incentives

Table 1: ESOP Pool Size Benchmarks by Stage

Step 3: Exercise Price Design

The exercise price is the single most impactful design decision in an ESOP scheme. It determines the employee's cost of exercising, the tax treatment, and the perceived value of the grant. Common approaches:

Face value (Rs.10): Maximum upside for employees. Common in startups. Creates a large perquisite at exercise (FMV minus Rs.10 is taxed as salary).

Discount to FMV (e.g., 50% of FMV): Balances employee benefit with tax efficiency. Reduces the perquisite tax burden compared to face value exercise.

At FMV: No perquisite at exercise (since exercise price equals FMV). Entire gain is taxed as capital gains on eventual sale. Most tax-efficient for employees, but requires the employee to pay a higher price upfront.

KEY INSIGHT

We always advise founders to model the tax impact of different exercise prices before finalising the scheme. For a Rs.500 FMV share: at face value (Rs.10 exercise), the employee pays approximately Rs.145 in perquisite tax per share at the 30% slab. At FMV exercise (Rs.500), perquisite tax is zero. The difference in after-tax employee outcome over a 4-year period can be dramatic. The "most generous" exercise price (face value) is not always the most valuable to the employee after tax.

Step 4: Vesting Schedule

The vesting schedule determines when options become exercisable. The most common structures in India:

4-year graded vesting with 1-year cliff: 25% vests at the end of Year 1 (the "cliff"), then remaining 75% vests monthly or quarterly over the next 3 years. This is the Silicon Valley standard and the most common structure in Indian startups.

Time-based uniform vesting: Equal portions vest annually (e.g., 25% per year for 4 years). Simpler to administer but lacks the retention power of a cliff.

Performance-based vesting: Options vest upon achievement of specified milestones (revenue targets, profitability, product launch). More complex to administer and value (Ind AS 102 requires probability-weighting, while under Indian GAAP, only intrinsic value method is used), but directly ties equity to performance.

Accelerated vesting on trigger events: Options vest immediately upon change of control (acquisition) or IPO. Protects employees in exit scenarios but can create misaligned incentives (employees pushing for early exit).

PRO TIP

The Companies Act mandates a minimum vesting period of 1 year. However, we strongly recommend a minimum 1-year cliff for practical reasons: it protects the company from granting equity to employees who leave within the first year, and it creates a meaningful

retention milestone. For senior leadership hires, consider a longer cliff (18-24 months) with accelerated vesting thereafter.

SECTION 2: DESIGNING THE ESOP

Chapter 4: Employee Coverage - Who Gets Options and How Many

One of the most sensitive decisions in ESOP design is determining eligibility: who gets options, how many, and on what basis. This is where business strategy, compensation philosophy, and organisational culture intersect.

Eligibility Framework

Under the Companies Act, 2013, ESOPs can be granted to:

- (1) Permanent employees working in India or outside India;
- (2) Directors of the company (excluding independent directors and promoter directors holding >10%);
- (3) Employees of subsidiary companies or holding companies (with appropriate approvals).

SEBI Regulations additionally allow grants to employees of group companies for listed entities. However, the following are explicitly excluded: promoters and promoter group members, independent directors, and directors holding directly or indirectly more than 10% of outstanding equity.

Grant Sizing: How Many Options Per Employee?

Grant sizing is as much art as science. The objective is to ensure that the equity grant is large enough to be meaningful to the employee while not over-diluting existing shareholders. Common methodologies include the percentage of pool approach, the Rupee value approach (targeting a specific notional value for each level), and competitive benchmarking using industry compensation surveys. In Indian tech companies, equity typically comprises 15-35% of total compensation for senior roles.

Practical Example: ESOP Allocation for a Series B SaaS Startup

Company: 150 employees, Rs.50 Cr ARR, Series B at Rs.500 Cr valuation, 10% ESOP pool (5,00,000 options)

Level	Headcount	Options Per Person	Total Options	% of Pool
CTO / CXO	3	50,000	1,50,000	30%
VP / Director	8	15,000	1,20,000	24%
Senior Manager	20	5,000	1,00,000	20%
Manager / Lead	35	2,000	70,000	14%
Individual Contributor	40	1,500	60,000	12%
Total	106	-	5,00,000	100%

Table 2: Illustrative ESOP Allocation - Series B SaaS Startup

Note: Not all 150 employees receive ESOPs. 106 of 150 (71%) are included. The remaining 44 employees (typically in junior roles or recent hires still in probation) are excluded from this tranche but may be eligible in future grants.

Refresher Grants and Top-Ups

An initial ESOP grant loses retention power as vesting completes. Best practice is to implement refresher grants - additional option grants made to existing employees, typically annually, based on performance and retention priority. In mature ESOP programs, we recommend budgeting 20-30% of the annual ESOP pool for refresher grants, with the remainder reserved for new hires and promotions.

KEY INSIGHT

The most common mistake in ESOP allocation is “peanut butter spreading” - giving small, roughly equal grants to everyone. This creates a situation where no one’s grant is large enough to be motivating. We advocate for concentration: give meaningful grants to the 20-30% of employees who drive 80% of value creation, and use cash bonuses for the rest. A 50,000-option grant that could be worth Rs.50 Lakh changes behaviour; a 1,000-option grant worth Rs.1 Lakh does not.

ESOP Communication: The Most Underrated Success Factor

We have seen technically perfect ESOP schemes fail because employees did not understand them. The value of an ESOP is only realised if the employee appreciates what they have been given. Best practices for ESOP communication include: scenario analysis at the offer stage; personalised grant letters with one-page summaries; annual Total Compensation Statements showing cash plus benefits plus estimated ESOP value (many companies now use dedicated ESOP management platforms for real-time employee visibility); group tax impact sessions before exercise windows; and clear communication about IPO lock-in periods, insider trading windows, and tax planning strategies during liquidity events.

SECTION 3: ESOP VALUATION

Chapter 5: Valuation at Grant Date - Black-Scholes and Beyond

ESOP valuation is required at the grant date for accounting purposes. Under **Ind AS 102** (Share-Based Payment), the fair value of the option at grant date is the basis for recognising compensation expense over the vesting period. Under **Indian GAAP** (Guidance Note on Accounting for Employee Share-Based Payments issued by ICAI, and the framework of AS 15), companies may use either the fair value method or the intrinsic value method, though the fair value method is recommended. Getting this valuation right has direct, multi-year P&L implications.

The Black-Scholes Option Pricing Model

The Black-Scholes model is the most widely used method for ESOP valuation in India. Originally designed for exchange-traded options, it requires adaptation for employee stock options which have unique features (vesting conditions, non-transferability, early exercise behaviour).

Key inputs:

Share price (S): FMV of the underlying share on the grant date. For listed companies, this is the market price. For unlisted companies, this requires a separate valuation (DCF or NAV under the applicable rules prescribed under the Income Tax Rules, 2026, corresponding to erstwhile Rule 11UA of the Income Tax Rules, 1962).

Exercise price (K): The price at which the employee can purchase shares. Set by the ESOP scheme.

Time to expiry (T): Expected life of the option. For ESOPs, this is typically shorter than the contractual term due to early exercise behaviour. A common approach: use 60-75% of the contractual exercise period.

Risk-free rate (r): Yield on Government of India securities matching the expected option life. Currently 6.8-7.2% for 3-5 year tenors.

Volatility (σ): For listed companies, historical share price volatility over a period matching the expected option life. For unlisted companies, use historical volatility of comparable listed peers - this is the most judgment-intensive input.

Dividend yield (q): Expected annual dividend as a percentage of share price. Dividends reduce call option value since option holders do not receive dividends during the vesting period.

Practical Example: Black-Scholes Valuation

Company: Unlisted SaaS startup, FMV per share: Rs.500, Exercise price: Rs.100, Expected life: 4 years, Risk-free rate: 7.0%, Volatility: 55% (based on listed SaaS peer median), Dividend yield: 0%

Black-Scholes Value per Option: Rs.421

This means the share-based payment expense for each option granted is Rs.421, to be amortised over the 4-year vesting period (Rs.105 per year per option). For a grant of 10,000 options, the total P&L expense is Rs.42.1 Lakh over 4 years.

Note on Indian GAAP: Companies applying Indian GAAP that elect the intrinsic value method would recognise an expense based on the intrinsic value at grant date (FMV minus

exercise price = Rs.400 per option in this example), with mandatory pro-forma disclosure of the impact of using the fair value method.

When to Use the Binomial Model Instead

The Binomial (lattice) model is more flexible than Black-Scholes and is preferred when:

- (1) The option has American-style exercise features;
- (2) There are performance-based vesting conditions;
- (3) The company needs to model early exercise behaviour explicitly;
- (4) Dividend policy is expected to change over the option life.

In practice, the difference between Black-Scholes and Binomial values is typically 5-15%. For most Indian ESOPs with standard features, Black-Scholes is sufficient. For complex schemes with performance conditions or unusual exercise features, the Binomial model is more appropriate.

KEY INSIGHT

The most contentious input in any ESOP valuation is volatility. For unlisted companies, there are no directly observable share price movements, so we rely on listed peer volatility. We typically select the Index of the sector to which the company belongs or 3-5 listed companies in the same sector, compute historical volatility over a period matching the expected option life, and use the median.

Monte Carlo Simulation for Complex ESOPs

For ESOPs with performance-based vesting conditions (e.g., options vest only if the company achieves Rs.100 Cr revenue), neither Black-Scholes nor Binomial models are adequate. Monte Carlo simulation models thousands of possible share price paths and performance outcomes, probability-weighting the option value across all scenarios.

Under **Ind AS 102**, market conditions (share price targets) are reflected in the fair value at grant date and are NOT subsequently adjusted even if the condition is not met. Non-market conditions (revenue targets, profit targets) are reflected through the expected number of options that will vest and ARE adjusted as actuals emerge. **Under Indian GAAP**, where the intrinsic value method is used, these distinctions are less relevant since the expense is based on intrinsic value; however, companies using the fair value method under Indian GAAP should follow the same principles.

Valuation for Different ESOP Structures

The valuation methodology varies by instrument type. For standard ESOPs with time-based vesting, Black-Scholes is sufficient. For equity-settled SARs, Black-Scholes is applied with the reference price as the exercise price. For cash-settled SARs and phantom stocks, the liability is measured at fair value at each reporting date (mark-to-market under Ind AS 102) or at intrinsic value (under Indian GAAP).

SECTION 3: ESOP VALUATION

Chapter 6: Valuation at Exercise - FMV Determination

While grant date valuation determines the accounting expense, exercise date valuation determines the tax liability for the employee. The perquisite taxable under Section 17 of the Income Tax Act, 2025 is calculated as: FMV at exercise minus exercise price. This makes the exercise date FMV determination critically important.

FMV Determination for Listed Companies

For listed companies, FMV at exercise is straightforward: it is the closing market price on the exercise date (or the average of the highest and lowest trading price on that date, depending on the scheme terms). SEBI Regulations prescribe specific pricing norms for listed company ESOPs.

FMV Determination for Unlisted Companies

For unlisted companies, FMV must be determined by a merchant banker or as per the method prescribed under the applicable rules of the Income Tax Rules, 2026 (corresponding to erstwhile Rule 11UA of the Income Tax Rules, 1962). The two prescribed methods are:

Net Asset Value (NAV) Method: $FMV = (\text{Net Assets as per balance sheet}) / (\text{Total number of shares})$. All assets must be restated to fair value. This method often understates FMV for profitable, high-growth companies because it does not capture future earnings potential.

DCF Method: FMV is determined by discounting projected future cash flows. Must be certified by a SEBI-registered Merchant Banker. This method better reflects the intrinsic value of growth companies but requires projections that must be defensible.

Practical challenge: The FMV at exercise may be significantly higher than the FMV at grant (especially if the company has grown), creating a large perquisite tax liability for the employee. This is the “ESOP tax shock” that catches many employees off guard.

Case Study: The ESOP Tax Surprise

An employee at a Bangalore-based SaaS company was granted 10,000 options at Rs.10 exercise price when the company was valued at Rs.100 Cr (Rs.100 per share). Four years later, at exercise, the company had raised a Series C at Rs.1,000 Cr valuation (Rs.1,000 per share).

Perquisite per option: $Rs.1,000 \text{ (FMV)} - Rs.10 \text{ (exercise price)} = Rs.990$. Total perquisite: $10,000 \times Rs.990 = Rs.99 \text{ Lakh}$. Tax at 30% slab + cess: approximately Rs.31 Lakh.

The employee needed to pay Rs.31 Lakh in tax at the time of exercise, even though the shares were unlisted and could not be sold immediately. This is the liquidity crunch that makes ESOP tax planning essential.

Strategies to Manage Exercise Date Tax

Cashless exercise: The company facilitates a simultaneous exercise-and-sale (where possible), so the employee does not need to fund the exercise price or tax from personal savings.

Partial exercise: Employee exercises a portion of vested options each year, spreading the perquisite across multiple tax years to manage slab rate impact.

Exercise timing: If the company is expected to do a down round or if FMV is temporarily lower, exercising during that window reduces the perquisite.

DPIIT startup deferral: For eligible startups, perquisite tax is deferred for up to 48 months from the end of the tax year in which shares are allotted, or until the shares are sold or employment ceases, whichever is earlier (more on this in Chapter 7).

KEY INSIGHT

We always recommend that companies conduct an “ESOP tax impact” session with employees at least 6 months before a major exercise window. Many employees - especially those exercising for the first time - are shocked by the tax liability. A well-communicated tax estimate, along with exercise strategies (partial exercise, timing optimisation), prevents resentment and helps employees make informed decisions. The best ESOP programs treat financial literacy as part of the benefit.

PRO TIP

For unlisted companies with multiple exercise events per year, we recommend establishing a “valuation calendar” - pre-scheduled quarterly dates on which FMV is determined. All exercises within that quarter use the same FMV. This reduces valuation costs, ensures consistency, and simplifies TDS computation. The quarterly FMV should be determined within 30 days before the exercise window opens.

SECTION 4: TAXATION

Chapter 7: Tax Treatment for Employees

ESOP taxation in India follows a **two-stage tax event model**. Understanding this model is the single most important financial literacy requirement for any ESOP holder.

Important Note on the Income Tax Act, 2025

The Income Tax Act, 2025 (replacing the Income Tax Act, 1961) came into effect on 1 April 2026. While the substantive ESOP tax treatment remains unchanged, section numbers, rule references, form numbers, and terminology have been reorganised. The term “Tax Year” replaces the erstwhile “Previous Year” and “Assessment Year” concepts. Key ESOP-related mappings include: Section 17(2) of the 1961 Act corresponds to Section 17 of the 2025 Act (perquisites); Section 37(1) corresponds to Section 32 (general business deductions); Section 80-IAC has an equivalent provision under the new Act for eligible startup deductions; Rule 11UA of the 1962 Rules corresponds to the equivalent rule under the Income Tax Rules, 2026; Form 16 is replaced by Form 130 from 1 April 2026; and Section 201(1A) on TDS default interest has a corresponding provision under the 2025 Act. All references in this guide reflect the position under the Income Tax Act, 2025, with erstwhile 1961 Act references provided in parentheses for transitional clarity.

Stage 1: Tax at Exercise (Perquisite Tax)

When an employee exercises stock options, the difference between the Fair Market Value (FMV) on the date of exercise and the exercise price paid by the employee is treated as a perquisite under Section 17 of the Income Tax Act, 2025 (corresponding to Section 17(2) of the 1961 Act). This is taxed as salary income at the employee’s applicable slab rate.

Perquisite = FMV at Exercise - Exercise Price

Key points: The employer is required to deduct TDS on this perquisite. For unlisted companies, FMV is determined as per the applicable rules under the Income Tax Rules, 2026. The perquisite is reported in the employee’s Form 130 (replacing the erstwhile Form 16 from Tax Year 2026-27 onwards) and is included in taxable salary for the tax year of exercise.

Stage 2: Tax at Sale (Capital Gains Tax)

When the employee subsequently sells the shares acquired through ESOP exercise, the gain is taxed as capital gains. The cost of acquisition for capital gains purposes is the FMV at the date of exercise (not the exercise price paid).

Capital Gain = Sale Price - FMV at Exercise

Scenario	Holding Period	Tax Rate (2026)
Listed shares - LTCG	>12 months from exercise	12.5% above Rs.1.25 Lakh exemption
Listed shares - STCG	<12 months from exercise	20%
Unlisted shares - LTCG	>24 months from exercise	12.5% (without indexation)
Unlisted shares - STCG	<24 months from exercise	As per slab rate

Table 3: Capital Gains Tax Rates on ESOP Shares (Tax Year 2026-27 onwards)

The DPIIT Startup Tax Deferral

For employees of DPIIT-recognised startups (eligible startups as defined under the provisions corresponding to erstwhile Section 80-IAC), the perquisite tax at exercise is deferred - it is not payable at the time of exercise. Instead, tax becomes payable at the earliest of: (1) Expiry of 48 months from the end of the tax year in which shares are allotted; (2) Date of sale of shares; (3) Date of cessation of employment.

Important limitations: The deferral applies only to the perquisite component (Stage 1 tax). Capital gains tax (Stage 2) applies normally. The startup must be recognised by DPIIT and must be an “eligible startup” under the Income Tax Act. The deferral does not reduce the tax - it only postpones the payment.

KEY INSIGHT

The DPIIT deferral is often misunderstood as a tax exemption. It is not. It is a deferral - the tax is still payable, just later. And critically, if the employee leaves the company before selling the shares, the deferred tax becomes payable immediately upon cessation of employment. We have seen employees leave startups and receive unexpected tax demands for deferred ESOP perquisites. Companies must ensure employees understand this condition clearly at the time of grant.

Example: Complete Tax Computation

Employee receives 20,000 options of a listed company at Rs.10 exercise price. After 4 years, exercises all options when FMV is Rs.800. Holds shares for 18 months, then sells at Rs.1,200 on the stock exchange.

Perquisite at exercise: $(Rs.800 - Rs.10) \times 20,000 = Rs.1.58 \text{ Crore}$ - taxed as salary at 30% + cess = approximately Rs.49.3 Lakh TDS

Holding period: 18 months - qualifies as LTCG

Capital gain at sale: $(Rs.1,200 - Rs.800) \times 20,000 = Rs.80 \text{ Lakh}$ - LTCG at 12.5% above Rs.1.25L exemption = Rs.9.86 Lakh

Total tax paid: Rs.49.3L + Rs.9.86L = Rs.59.16 Lakh

Net proceeds: Rs.2.40 Cr (sale) - Rs.2L (exercise price) - Rs.59.16L (tax) = Rs.1.79 Crore

Key takeaway: The employee invested Rs.2 Lakh and paid Rs.59.16 Lakh in total tax, realising Rs.1.79 Crore after tax. The effective rate on total gain is approximately 25% - lower than the 30%+ marginal rate because the capital gains portion attracts the lower LTCG rate.

PRO TIP

For tax planning purposes, employees should model three scenarios: (1) Exercise and hold (immediate perquisite tax, deferred capital gains); (2) Exercise and sell immediately (perquisite tax + STCG in same year); (3) Partial exercise over multiple tax years (spread perquisite across tax years). The optimal strategy depends on the employee's total income, expected share price trajectory, and liquidity needs. We always recommend employees consult a tax advisor before exercising.

SECTION 4: TAXATION

Chapter 8: Tax Implications for Employers

While employees bear the direct tax on ESOP perquisites and capital gains, employers face their own set of tax considerations - TDS obligations, deductibility of ESOP expenses, cross-border recharge structures, and the interaction between ESOP accounting (Ind AS 102 / AS 15) and tax treatment.

TDS Obligations on ESOP Perquisite

The employer is required to deduct TDS on the perquisite value (FMV at exercise minus exercise price) at the time of exercise. This TDS must be deposited with the government within the prescribed timelines. Failure to deduct TDS exposes the employer to interest under the corresponding provision of the Income Tax Act, 2025 (equivalent to erstwhile Section 201(1A) of the 1961 Act) and potential penalties.

Practical challenge: The perquisite is a non-cash benefit - the employee receives shares, not cash. But TDS must be paid in cash. Solutions include: deducting TDS from the employee's salary in the month of exercise; requiring the employee to fund the TDS amount before shares are allotted; or implementing a "sell-to-cover" mechanism where a portion of shares are sold to fund the tax.

Deductibility of ESOP Expense

The tax deductibility of ESOP expenses has been a contentious issue in India. Under Ind AS 102 (or AS 15 under Indian GAAP), the ESOP expense recognised in the P&L is a non-cash charge. The Income Tax Act does not have a specific provision allowing deduction for ESOP expenses. However, various tribunal decisions have allowed deduction under Section 32 of the Income Tax Act, 2025 on the ground that ESOP compensation is incurred wholly and exclusively for the purpose of business.

Cross-Border ESOP Tax Structuring

When a US parent company grants ESOPs to employees of its Indian subsidiary, several tax and regulatory issues arise:

Recharge/reimbursement: The Indian subsidiary typically reimburses the parent for the cost of the ESOP (the share-based payment expense). This recharge must be at arm's length for transfer pricing purposes.

Withholding tax on recharge: The reimbursement payment from the Indian subsidiary to the parent must be analysed for withholding tax implications. If characterised as fees for technical services, it may attract 10-15% withholding tax under the applicable DTAA.

FEMA compliance: The allotment of parent company shares to Indian employees constitutes a cross-border security transaction and must comply with FEMA regulations.

Section 17 compliance: The Indian subsidiary (as the employer) is responsible for TDS on the perquisite, even though the shares are issued by the parent company. Determining the FMV of parent company shares for Indian tax purposes requires conversion at the applicable exchange rate.

KEY INSIGHT

Cross-border ESOP structuring is one of the most complex areas in Indian tax practice. We have seen companies get the FEMA filing wrong (resulting in compounding applications),

the transfer pricing wrong (resulting in TP adjustments), and the TDS wrong (resulting in interest and penalties). The key is to design the recharge structure upfront - before the first grant is made - with input from tax, transfer pricing, and FEMA advisors simultaneously. Retrofitting compliance after grants have been made is exponentially more expensive.

PRO TIP

For employers, the most overlooked tax obligation is the reporting requirement. Form 130 (replacing the erstwhile Form 12BA and Form 16 from Tax Year 2026-27) must accurately reflect the ESOP perquisite for each employee. Errors in salary reporting create problems for employees during their ITR filing and can trigger demand notices from the CPC. Invest in getting the payroll integration right from the start.

SECTION 5: COMPLIANCE & REGULATORY FRAMEWORK

Chapter 9: Companies Act, SEBI & FEMA Compliance

ESOP implementation in India sits at the intersection of three regulatory frameworks: the Companies Act, 2013 (for all companies), SEBI regulations (for listed companies), and FEMA (for cross-border structures). Navigating all three simultaneously is where most implementation errors occur.

Companies Act, 2013 Requirements

The foundational legal framework for ESOPs is Section 62(1)(b) read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014. Key requirements include: special resolution with 75% majority, minimum vesting period of 1 year from the date of grant, non-transferability of options, Board's report disclosures covering details of options granted/vested/exercised/lapsed, and filing of Form PAS-3 within 30 days of allotment of shares upon exercise.

SEBI Regulations, 2021 (Listed Companies)

Listed companies must comply with the SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021, which impose additional requirements including: a Compensation Committee (minimum 3 directors, majority independent) to administer the scheme; prescribed scheme limits on maximum dilution; annual disclosures to stock exchanges; insider trading compliance under SEBI PIT Regulations; and maintenance of a register of options.

FEMA Compliance for Cross-Border ESOPs

When an Indian company's ESOP involves shares of a foreign parent or when a foreign company grants options to Indian employees, FEMA compliance is mandatory. This includes ODI regulation compliance, Annual Return on Foreign Liabilities and Assets (FLA return) to RBI, and repatriation of sale proceeds within prescribed timelines.

KEY INSIGHT

The regulatory landscape for ESOPs is a three-body problem: Companies Act, SEBI, and Income Tax/FEMA each have their own requirements, timelines, and compliance calendars. We maintain a consolidated ESOP compliance checklist for each client that maps every obligation across all three frameworks, with due dates and responsible persons. This single document has prevented more compliance failures than any other tool in our practice.

ESOP Administration: Technology and Compliance

Managing ESOP compliance manually (through spreadsheets and email) becomes untenable as the program scales beyond 50-100 employees. Dedicated ESOP management platforms offer: centralised grant and vesting tracking, automated exercise workflows, real-time employee dashboards showing option value, TDS computation and salary reporting integration, SEBI disclosure generation for listed companies, and cap table management.

PRO TIP

Our compliance golden rule for ESOP programs: every ESOP action (grant, vest, exercise, lapse, modification) should be documented in the board minutes or ESOP committee minutes, reflected in the ESOP register within 7 days, and communicated to the employee in writing. If an action is not documented, it did not happen - at least as far as regulators and auditors are concerned.

SECTION 5: COMPLIANCE & REGULATORY FRAMEWORK

Chapter 10: Accounting for Share-Based Payments - Ind AS 102 & Indian GAAP

The accounting treatment for ESOPs and other equity compensation instruments is governed by **Ind AS 102** (Share-Based Payment) for companies reporting under Ind AS, and by the **ICAI Guidance Note on Accounting for Employee Share-Based Payments** (and the framework of AS 15) for companies reporting under Indian GAAP. For many companies, the share-based payment expense is the most significant non-cash charge on the P&L - and one of the most frequently misunderstood.

Key Differences: Ind AS 102 vs. Indian GAAP

The choice of accounting framework has a material impact on the quantum of ESOP expense recognised. The table below summarises the critical differences:

Aspect	Ind AS 102	Indian GAAP (Guidance Note / AS Framework)
Measurement basis	Fair value at grant date (mandatory)	Fair value (recommended) OR intrinsic value (permitted)
Intrinsic value option	Not permitted	Permitted; if intrinsic value is used, pro-forma fair value disclosure is mandatory
Expense for at-the-money options	Yes - time value component is recognised as expense	Zero expense if intrinsic value method is used (since intrinsic value = nil)
Subsequent remeasurement (equity-settled)	No remeasurement after grant date	No remeasurement under fair value method; intrinsic value may require adjustment at each reporting date under some interpretations
Cash-settled instruments	Mark-to-market at each reporting date until settlement	Generally recognised at intrinsic value; fair value approach permitted
Forfeiture treatment	Estimate expected forfeitures at grant; true-up to actuals	Similar approach; true-up to actuals
Modification accounting	Incremental fair value recognised; no reversal for value decrease ("one-way ratchet")	Less prescriptive; generally follows similar principles where fair value method is used
Cancellation and replacement	Original expense continues; incremental fair value of replacement recognised	Less detailed guidance; professional judgement required
Disclosure requirements	Extensive disclosures mandated (number, WAEP, fair value inputs, expense)	Disclosures required but less granular than Ind AS 102

Table: Key Accounting Differences - Ind AS 102 vs. Indian GAAP

Practical Implication: At-the-Money Options

The most consequential difference between the two frameworks arises for options granted at exercise price equal to FMV (“at-the-money” options). Under Ind AS 102, even at-the-money options carry time value and must be expensed using the Black-Scholes or Binomial model. Under Indian GAAP, if the company uses the intrinsic value method, the intrinsic value of an at-the-money option is nil, resulting in zero expense. This creates a significant gap in P&L impact between the two frameworks for identically structured ESOP schemes. Companies transitioning from Indian GAAP to Ind AS should model this impact carefully, as the P&L restatement can be material.

The Core Principle Under Ind AS 102

Ind AS 102 requires that equity-settled share-based payments (including ESOPs) be measured at fair value at grant date and recognised as an expense over the vesting period. The fair value is not subsequently remeasured for changes in the share price or option value. This means the P&L expense is “locked in” at grant date - making the grant date valuation critically important.

Total ESOP Expense = Fair Value per Option × Number of Options Expected to Vest

The expense is recognised on a straight-line basis over the vesting period (or on a graded basis if the scheme has graded vesting with separately identifiable tranches).

Treatment of Forfeitures

When employees leave before their options vest, the unvested options are forfeited. Both Ind AS 102 and Indian GAAP require the company to estimate expected forfeitures at grant date and adjust the number of options expected to vest. As actual forfeitures occur, the cumulative expense is trued up. Companies with high employee attrition will have lower net share-based payment expenses. However, the forfeiture estimate must be reasonable and documented - using an arbitrary forfeiture rate without supporting data will be challenged by auditors.

Modification Accounting

When a company modifies the terms of an existing ESOP, Ind AS 102 requires : the original expense continues to be recognised based on the original grant date fair value; if the modification increases the fair value, the incremental fair value is recognised as additional expense; if the modification decreases the fair value, the decrease is ignored. This “one-way ratchet” means modifications can only increase the total expense. Under Indian GAAP, while the guidance is less prescriptive, companies using the fair value method generally follow similar principles.

Practical Example: Expense Computation

Company grants 1,00,000 options with fair value of Rs.200 per option, 4-year vesting, expected forfeiture rate of 15%.

Options expected to vest: $1,00,000 \times (1 - 15\%) = 85,000$. Total expense: $85,000 \times \text{Rs.}200 = \text{Rs.}1.70 \text{ Crore}$. Annual expense (straight-line): $\text{Rs.}1.70 \text{ Cr} / 4 = \text{Rs.}42.5 \text{ Lakh per year}$.

If actual attrition is higher than expected (say 20% forfeit instead of 15%), the cumulative expense is adjusted downward in the year the true-up is recorded.

PRO TIP

The most common share-based payment accounting errors we encounter: (1) Not recognising any expense for options granted at exercise price equal to FMV - even at-the-money options have time value and must be expensed under Ind AS 102 (though zero expense may be

appropriate under Indian GAAP if using intrinsic value method); (2) Using the contractual term instead of expected term in Black-Scholes; (3) Not adjusting for expected forfeitures; (4) Treating all tranches of graded vesting as a single award instead of separately identifiable tranches. Each of these errors can result in material misstatement of the ESOP expense.

Impact on EPS and Financial Ratios

Share-based payment expense directly impacts key financial metrics: diluted EPS (outstanding “in the money” options are included in diluted share count under Ind AS 33 or AS 20, as applicable); EBITDA vs. adjusted EBITDA (PE investors often add back the expense as a non-cash charge); and operating margins (for tech companies with large ESOP programs, the expense can reduce operating margins by 3-8 percentage points).

Pre-IPO Restatement

Companies preparing for IPO often discover incomplete or incorrect historical ESOP accounting. The prospectus requires Ind AS-compliant restated financials including proper share-based payment expense from inception. We strongly recommend companies planning an IPO within 3-5 years implement compliant accounting from the start - the upfront cost is a fraction of retrospective restatement during the IPO process.

SECTION 6: STRATEGIC CONSIDERATIONS

Chapter 11: Employer Playbook - Making ESOPs Work for the Company

An ESOP that is well-designed on paper can still fail in practice if the employer does not actively manage it as a strategic tool. This chapter covers the decisions and actions that separate companies where ESOPs drive real value from those where they become an expensive, resentment-generating compliance exercise.

Building an ESOP Culture

The most successful ESOP programs share a common trait: the company actively educates employees about what their options mean, how they work, and what they could be worth. This is not a one-time onboarding slide - it is an ongoing communication program. Key touchpoints include: explaining scenarios at grant, providing annual Total Compensation Statements, conducting tax impact workshops before exercise windows, and providing clear guidance during exit events such as IPO or acquisition.

ESOP Trust vs. Direct Route

Companies can administer ESOPs either directly (issuing new shares upon exercise) or through an ESOP Trust (which acquires shares in advance and transfers them to employees upon exercise). The **direct route** is simpler and most common for startups. The **ESOP Trust route** avoids multiple small allotments, enables buyback of exercised shares, and provides structured administration - commonly used by listed companies and larger unlisted companies. Tax implications of the ESOP Trust must be structured carefully, as the transfer of shares from the trust to employees triggers the perquisite tax event.

Buyback and Liquidity Mechanisms

For unlisted companies, the biggest employee complaint about ESOPs is illiquidity. Progressive companies address this through periodic buyback programs, secondary sale windows during funding rounds, and dedicated ESOP management platforms that facilitate secondary transactions in unlisted company shares.

KEY INSIGHT

The companies we advise that get the best results from their ESOP programs all share one practice: they treat the ESOP pool as a strategic asset, not an HR administration item. The CEO reviews ESOP utilisation quarterly. The CFO models the dilution and expense impact. The HR head tracks the correlation between ESOP grants and retention outcomes. And the board reviews the ESOP program annually as part of the overall compensation strategy. When ESOPs are managed with this level of rigour, they are the most powerful talent tool available.

ESOP in M&A: Acceleration, Cancellation, and Rollover

When a company with an active ESOP program is acquired, treatment of outstanding options becomes a critical deal point. Three common approaches: **Acceleration** (all unvested options vest immediately upon change of control); **Cancellation with cash-out** (outstanding options are cancelled with cash payment for the spread); and **Rollover** (outstanding options are converted into acquirer's options on equivalent terms). The ESOP scheme document should clearly specify the treatment upon change of control.

Measuring ESOP Program Effectiveness

Key metrics to track include: retention rate of ESOP holders vs. non-holders; cost per retained employee; pool utilisation percentage; employee understanding score (via surveys); and exercise rate (percentage of vested options actually exercised).

SECTION 6: STRATEGIC CONSIDERATIONS

Chapter 12: Employee Playbook - Understanding Your ESOP

If you are an employee who has been granted stock options, this chapter is written specifically for you. ESOPs can be the most valuable component of your compensation - but only if you understand how they work, what they are worth, and how to make smart decisions about exercising, holding, and selling.

Understanding Your Grant Letter

Your ESOP grant letter contains the key terms that determine the value of your options. Read it carefully and understand: the number of options, the exercise price (fixed at the time of grant), the vesting schedule, the exercise period, and the post-termination exercise period (often 30-90 days - much shorter than most people expect).

Calculating What Your Options Are Worth

Option Value = (Current FMV per share - Exercise Price) × Number of Vested Options

Example: You have 10,000 options with an exercise price of Rs.50. The company's last funding round valued shares at Rs.500 each. Your vested options (say 5,000 after 2 years) are worth: $(Rs.500 - Rs.50) \times 5,000 = Rs.22.5$ Lakh. But remember: this is pre-tax value. After perquisite tax at 30%, your after-tax value is approximately Rs.15.75 Lakh.

Important caveat: The "value" of your options is theoretical until you can actually sell the shares. For unlisted companies, there may be no market for the shares.

The Exercise Decision: When and How

Key factors to consider: **Tax timing** (exercising triggers perquisite tax immediately); **Cash outflow** (you need cash for both exercise price and tax); **Holding period** (holding for LTCG eligibility can save significant tax); and **Concentration risk** (your salary and ESOP value are both tied to the same company).

Five Questions Every ESOP Holder Should Ask

(1) What is the current FMV of the company's shares? (2) What is the company's path to liquidity? (3) What happens to my options if I leave? (4) What is my tax liability if I exercise today? (5) Is partial exercise possible?

Common Scenarios Every ESOP Holder Faces

Scenario 1: You get a better job offer. Before accepting, check how many options are vested, the post-termination exercise period (typically 30-90 days), and whether you can afford to exercise the vested options plus pay the tax before the deadline.

Scenario 2: The company is being acquired. Check whether the scheme has accelerated vesting on change of control, whether options will be cashed out or rolled over, and the per-share consideration relative to your exercise price.

Scenario 3: The company is going for IPO. Understand the lock-in period post-listing, insider trading window restrictions, and the tax implications of exercising pre-IPO vs. post-IPO.

Scenario 4: The company offers to buy back your shares. Evaluate the buyback price relative to the latest FMV and the tax treatment of buyback proceeds.

Evaluating ESOPs in Job Offers

When evaluating a job offer that includes ESOPs: **Discount heavily for risk** (50-70% for early-stage, 20-40% for late-stage); **Check the vesting schedule** (the cliff means you get nothing if you leave within 12 months); **Understand the exercise price** (factor in exercise cost and associated tax); **Ask about liquidity** (when and how you can convert options into cash); and **Get it in writing** (verbal promises are not enforceable).

PRO TIP

The single best piece of advice we give to ESOP holders: do not treat your options as “free money.” They involve real cash outflow (exercise price + tax), real risk (company may not achieve liquidity), and real opportunity cost. Model the scenarios, understand the tax, and make an informed decision. And always, always check the post-termination exercise period before accepting a new job offer - 30 days is very common and can catch you off guard.

Conclusion: Working With an ESOP Advisor

ESOPs are simultaneously one of the most powerful strategic tools available to Indian companies and one of the most complex to implement correctly. The intersection of company law, securities regulation, tax law, FEMA compliance, and accounting standards (both Ind AS 102 and Indian GAAP) creates a web of requirements where errors in any one dimension can undermine the entire program.

When to DIY

If you are a very early-stage startup with fewer than 10 employees and a simple ESOP structure (face value exercise, standard 4-year vesting), you can use template ESOP schemes and basic guidance from your company secretary.

When to Engage a Professional

Professional engagement is essential for: designing an ESOP scheme for the first time; ESOP valuation for Ind AS 102 / AS 15 compliance; cross-border ESOP structuring; listed company SEBI SBEB&SE compliance; ESOP restructuring or modification; pre-IPO ESOP cleanup and Ind AS restatement; tax advisory for large exercise events; and ESOP-related disputes or regulatory inquiries.

The Cost of Getting ESOPs Wrong

The consequences of ESOP implementation errors are disproportionately expensive: incorrect FMV determination can result in tax demands running into crores; Ind AS 102 restatement during IPO can delay the process by 3-6 months; listed companies face SEBI violations; poorly drafted schemes lead to employee litigation; and cross-border FEMA violations require compounding applications with penalties up to 3x the amount involved.

How Elite Valuation Can Help

ESOP Scheme Design: End-to-end plan architecture, legal drafting, board and shareholder resolution support.

ESOP Valuation: Black-Scholes, Binomial, Monte Carlo for grant and exercise dates.

Ind AS 102 & AS 15 Compliance: Expense computation, modification accounting, quarterly true-ups.

Tax Structuring: Employee and employer tax optimisation, TDS advisory, cross-border withholding.

SEBI Compliance: Listed company filings, compensation committee support.

Cross-Border ESOPs: FEMA structuring, transfer pricing, recharge agreements.

Sagar Shah | CA, CS, IBBI Registered Valuer | All India Rank Holder

Phone: +91 7600008550 | Email: sagarrvshah@elitevaluation.in

Website: www.EliteValuation.in | ESOP: www.Esopservice.com

“An ESOP is not a benefit - it is a strategic tool. When designed well, it aligns the interests of the people who build the company with the people who own it.”

- Sagar Shah

© 2026 Elite Valuation. All rights reserved.