
ESOP TAXATION, STARTUPS AND EMPLOYEE MOBILITY: IS CURRENT TAX LAW KILLING INDIA'S TALENT INCENTIVES?

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ABSTRACT

The India's Employee Stock Option Plan (ESOP) taxation regime imposes perquisite tax at exercise on the spread between fair market value and strike price, creating a liquidity-taxation mismatch that undermines equity compensation effectiveness. This paper examines whether alternative tax treatments would better align startup talent incentives without compromising revenue integrity. Through doctrinal analysis of the Income Tax Act, 1961, particularly Sections 17(2)(vi) and 80-IAC, economic modeling of employee outcomes, and comparative study of frameworks in the United States, United Kingdom, and Israel, this research identifies critical structural failures. Current taxation forces employees to fund substantial tax liabilities on illiquid paper gains, while Section 80-IAC's cessation-of-employment trigger converts ESOPs from incentives into golden handcuffs that constrain career mobility. Comparative analysis reveals that all three benchmark jurisdictions defer or eliminate exercise taxation, recognizing illiquid equity should not trigger immediate cash obligations. This paper proposes three alternative models: full deferral to sale with capital gains treatment, safe harbor valuations with tax credit mechanisms, and expanded deferral with modified triggers. Recommendations prioritize eliminating the cessation trigger and adopting Israel-inspired full deferral for recognized startups, accompanied by anti-abuse safeguards including exit taxation and enhanced valuation oversight. Reform would restore ESOPs as genuine talent incentives while maintaining revenue integrity through expanded tax base effects from increased startup success rates.

Keywords: ESOP taxation, startup compensation, employee mobility, tax deferral, Section 17(2)(vi), Section 80-IAC, perquisite taxation

I. Introduction

India's startup ecosystem has experienced exponential growth over the past decade, with over 117,000 recognized startups as of 2026, positioning the country as the third-largest startup hub globally.¹ Central to this growth has been the strategic use of Employee Stock Option Plans (ESOPs) as a compensation tool, enabling cash-constrained startups to attract and retain talent by offering equity participation in future value creation.² However, this compensation model operates within a tax framework that creates a fundamental paradox: employees face immediate tax liabilities on paper wealth they cannot access, often for years or even decades before any liquidity event occurs.³

Under the current regime governed by Section 17(2)(vi) of the Income Tax Act, 1961, ESOPs are taxed as perquisite income at the point of exercise, calculated as the difference between fair market value and exercise price, regardless of whether employees receive any cash.⁴ This treatment subjects employees to marginal tax rates of 30% or higher on notional gains, creating severe liquidity mismatches that can amount to several lakhs in immediate tax liability without corresponding cash inflows.⁵ For an employee exercising 10,000 options where the fair market value stands at ₹500 against a strike price of ₹10, the resulting perquisite of ₹49 lakh triggers a tax obligation exceeding ₹15 lakh, payable from personal savings or salary. Recent government discussions in January 2026 have acknowledged these challenges, yet meaningful reform remains elusive.⁶

The taxation problem extends beyond liquidity to fundamentally undermine employee mobility. The deferral provision under Section 80-IAC, introduced to provide relief, terminates upon cessation of employment, effectively trapping employees in their current roles to avoid

¹ See Ministry of Commerce and Industry, Startup India, <https://www.startupindia.gov.in> (last visited Jan. 30, 2026).

² See generally Ascentium, ESOPs for Indian Startups: A Preferred Tool for Hiring and Retaining Talent (Oct. 30, 2025), <https://www.ascentium.com/in/blog/esops-for-indian-startups-a-preferred-tool-for-hiring-and-retaining-talent/>.

³ See Ashutosh Bisht, India's ESOP Wealth Pool Is Massive but Illiquid, LinkedIn (Jan. 15, 2026), https://www.linkedin.com/posts/ashutosh-fact_indias-esop-wealth-pool-is-massive-but-activity-7417876228935966720-z1aj (describing "paper millionaire" phenomenon where employees hold illiquid wealth on cap tables).

⁴ Income Tax Act, 1961, § 17(2)(vi), No. 43 of 1961, India Code (2024).

⁵ See Court Kutchehry, ESOP Tax in India: Why the Bill Starts at Exercise and Smart Planning Tactics (Dec. 18, 2025), <https://www.courtkutchehry.com/pages/blog/esop-tax-india-perquisite-capital-gains-high-court-rulings>.

⁶ See Times of India, How to Make ESOPs More Valuable for Startup Staff (Jan. 26, 2026), <https://timesofindia.indiatimes.com/business/india-business/how-to-make-esops-more-valuable-for-startup-staff/articleshow/127575.cms> (reporting government deliberations on ESOP tax relief measures).

triggering deferred tax liabilities.⁷ This creates golden handcuffs that contradict the stated policy objective of incentivizing talent through equity participation. Meanwhile, jurisdictions like the United States, United Kingdom, and Israel have adopted alternative frameworks that defer taxation until actual sale, eliminating the liquidity-taxation mismatch while maintaining revenue integrity.⁸

This paper examines whether alternative tax treatments, specifically full deferral until sale or modified trigger mechanisms, would better align startup talent incentives without compromising tax revenue. Through doctrinal analysis of Indian tax law, economic modeling of employee outcomes under various scenarios, and comparative study of international frameworks, this research evaluates the viability and design of reform proposals that could restore ESOPs as genuine incentive instruments rather than compliance burdens.

II. CURRENT LEGAL FRAMEWORK: THE TWO-STAGE TAX REGIME

India's taxation of ESOPs operates through a bifurcated structure that imposes tax liability at two distinct points: first at exercise as perquisite income, and subsequently at sale as capital gains.⁹ This dual taxation framework, combined with limited deferral relief available only to eligible startups, creates the structural problems that undermine ESOP effectiveness as talent incentives.

A. Perquisite Taxation at Exercise

Section 17(2)(vi) of the Income Tax Act treats the benefit arising from exercise of stock options as salary income, calculated as the difference between the fair market value on the exercise date and the amount paid by the employee (exercise price), multiplied by the number of shares allotted.¹⁰ This perquisite is taxed at the employee's applicable marginal rate, which can reach 30% for high earners, plus applicable surcharge and cess.¹¹ Employers bear a corresponding

⁷ Income Tax Act, 1961, § 80-IAC, No. 43 of 1961, India Code (2024); see also Mind Your Tax, ESOP Taxation for Startups: Section 17(2)(vi) Analysis (Jan. 28, 2025), <https://mindyourtax.in/blogs/esop-taxation-for-startups-section-17-2-vi>.

⁸ See Nordic HQ, Startup Employee Stock Options: Country Comparison (Jan. 18, 2026), <https://www.nordichq.com/startup-employee-stock-options-country-comparison/> (comparing ESOP tax treatment across US ISO framework, UK EMI scheme, and Israeli Section 102 trust structure).

⁹ See Income Tax Act, 1961, §§ 17(2)(vi), 45, No. 43 of 1961, India Code (2024).

¹⁰ Income Tax Act, 1961, § 17(2)(vi), No. 43 of 1961, India Code (2024).

¹¹ Court Kutchehry, *supra* note 5.

obligation under Section 192 to withhold tax at source on this perquisite value, creating administrative compliance burdens alongside the employee's tax liability.¹²

Valuation requirements add another layer of complexity. For unlisted companies, determination of fair market value mandates valuation by a merchant banker registered with the Securities and Exchange Board of India, while listed companies use the trading price on recognized stock exchanges.¹³ This merchant banker valuation requirement, though intended to ensure accuracy, generates significant compliance costs and opens avenues for valuation disputes between taxpayers and tax authorities.

The practical challenges of this regime are severe. Most fundamentally, employees face immediate tax liability on notional gains without receiving any cash consideration, as the shares obtained through exercise remain illiquid and typically cannot be sold for years until a qualifying exit event occurs.¹⁴ An employee exercising options when fair market value substantially exceeds strike price must fund the tax obligation from existing savings or salary income, creating cash flow crises that can amount to lakhs of rupees. Timing controversies further complicate compliance, with conflicting tribunal rulings on whether the taxable event occurs at the moment of exercise or the subsequent date of share allotment, creating uncertainty in tax planning and withholding obligations.¹⁵

B. Capital Gains Taxation at Sale

Upon eventual sale of ESOP shares, employees face a second tax event. Capital gains are computed as the sale price minus the fair market value at exercise (not the original exercise price, which was already accounted for in perquisite taxation), classified as either short-term or long-term based on a 24-month holding period threshold.¹⁶ Long-term capital gains on unlisted equity shares are taxed at 20% with indexation benefit, while short-term gains attract

¹² Income Tax Act, 1961, § 192, No. 43 of 1961, India Code (2024).

¹³ Court Kutchehry, *supra* note 5; see also Income Tax Department, Taxation of Employee Stock Option Plan (ESOP), <https://incometaxindia.gov.in/Tutorials/50.Taxation-of-ESOPs.pdf> (last visited Jan. 30, 2026).

¹⁴ Times of India, *supra* note 6; Ashutosh Bisht, *supra* note 3.

¹⁵ See KPMG India, Perquisite Arises as on Date of Allotment of Shares Under ESOP (Nov. 14, 2018), <https://www.in.kpmg.com/taxflashnews/KPMG-Flash-News-Bharat-Financial-Inclusion-Ltd.pdf> (discussing Bombay High Court ruling on timing controversy).

¹⁶ See JM Financial Services, ESOP Taxation in India Explained (July 24, 2025), <https://www.jmfinancialservices.in/blogs-and-articles/understanding-esop-taxation>.

taxation at applicable marginal rates.¹⁷

This structure creates a double taxation concern that, while technically taxing different components of economic gain, subjects the same underlying appreciation to tax under two different heads of income.¹⁸ The perquisite component represents the spread at exercise, while capital gains capture post-exercise appreciation, but employees perceive this as duplicative taxation on their equity compensation, particularly when both taxes are paid before achieving any actual liquidity.

C. Startup Deferral Provision (Section 80-IAC)

Recognizing the liquidity challenges, Parliament introduced Section 80-IAC in the Finance Act 2020, providing conditional deferral of perquisite tax for employees of eligible startups.¹⁹ Eligibility requires recognition under the Startup India initiative, incorporation after April 1, 2016, and compliance with specified turnover thresholds.²⁰ Qualifying employees may defer tax payment until the earliest of: (i) expiry of 48 months (increased to five years in Budget 2024) from the year of exercise, (ii) sale of the shares, or (iii) cessation of employment.²¹

However, this deferral mechanism suffers from critical limitations. First, deferral does not constitute exemption; the tax liability merely shifts forward in time without reduction in quantum.²² Second, narrow eligibility criteria exclude growth-stage companies that have matured beyond startup classification, as well as employees of established technology firms that extensively use ESOPs. Most problematically, the cessation-of-employment trigger directly defeats the mobility objective by forcing employees to choose between career advancement through job changes and tax optimization through continued employment, effectively creating the golden handcuffs phenomenon that traps talent.²³

D. Judicial Inconsistency

Compounding statutory complexities, divergent High Court rulings have created uncertainty

¹⁷ Income Tax Act, 1961, §§ 112, 111A, No. 43 of 1961, India Code (2024).

¹⁸ Court Kutchehry, *supra* note 5.

¹⁹ Finance Act, 2020, § 80-IAC (amendment to Income Tax Act, 1961).

²⁰ Times of India, *supra* note 6; Ascentium, *supra* note 2.

²¹ Income Tax Act, 1961, § 80-IAC, No. 43 of 1961, India Code (2024); Times of India, *supra* note 6 (noting five-year extension in Budget 2024).

²² Court Kutchehry, *supra* note 5; Ascentium, *supra* note 2.

²³ Times of India, *supra* note 6; Ascentium, *supra* note 2.

regarding fundamental characterization questions, particularly whether voluntary ESOP compensation constitutes taxable perquisite or gift.²⁴ The Karnataka, Delhi, and Madras High Courts have adopted inconsistent approaches to timing and valuation questions, while the Supreme Court has not provided definitive guidance.²⁵ Similarly, the Central Board of Direct Taxes has not issued comprehensive clarificatory circulars addressing these controversies, leaving taxpayers and employers navigating compliance in an uncertain regulatory environment.²⁶

III. THE TALENT MOBILITY CRISIS: ECONOMIC & BEHAVIORAL ANALYSIS

The structural design of India's ESOP taxation regime creates economic consequences that extend far beyond immediate tax liability, fundamentally reshaping employee behavior, mobility patterns, and the competitive dynamics of startup talent acquisition. This section examines the quantitative and qualitative impacts of the liquidity-taxation mismatch on India's entrepreneurial ecosystem.

A. Liquidity-Taxation Mismatch

The core problem manifests clearly through quantitative modeling. Consider an employee exercising 10,000 stock options where the fair market value stands at ₹500 per share against a strike price of ₹10. The perquisite value under Section 17(2)(vi) equals ₹49 lakh, triggering an immediate tax liability of approximately ₹15 lakh at the 30% marginal rate (excluding surcharge and cess).²⁷ Critically, the employee receives no cash from this transaction; the entire tax obligation must be funded from personal savings or salary income. Subsequently, if the employee sells shares at ₹600 per share during a liquidity event, an additional capital gains tax applies to the ₹100 per share appreciation beyond the already-taxed fair market value, compounding the tax burden on what employees perceive as a single economic gain.²⁸

This problem is exacerbated by structural illiquidity in India's startup ecosystem. The average time from founding to a qualifying liquidity event through initial public offering or acquisition

²⁴ See TaxSutra, Tax Treatment of Voluntary ESOP Compensation in India (July 31, 2025), https://database.taxsutra.com/articles/5b9578cd8a0d08d0fe6ef98048c4df/expert_article (analyzing conflicting High Court approaches).

²⁵ Id.

²⁶ Court Kutchehry, *supra* note 5.

²⁷ Court Kutchehry, *supra* note 5.

²⁸ Id.

ranges from 10 to 12 years for Indian startups, meaning employees often wait over a decade before converting paper wealth into cash.²⁹ During this extended period, buyback opportunities remain discretionary and infrequent, typically occurring at 15% to 20% discounts to the most recent valuation round to account for illiquidity and tax considerations.³⁰ Secondary market transactions, while increasingly available through specialized platforms, price shares at significant illiquidity premiums that further reduce employee realizations.³¹ The result is a taxation regime that demands immediate cash payment on gains that may not materialize for years, if at all.

B. Impact on Employee Mobility

The cessation-of-employment trigger embedded in Section 80-IAC's deferral provision creates a golden handcuffs effect that directly constrains career mobility.³² Employees who have exercised options and deferred tax payment face an impossible choice: accept a superior opportunity at another firm and immediately trigger the deferred tax liability without corresponding liquidity, or remain in their current role to preserve tax deferral.³³ This mechanism converts ESOPs from incentive instruments into retention traps, fundamentally misaligning the policy objective of rewarding talent with the practical effect of limiting career advancement.

Unvested ESOPs compound this mobility constraint through sunk cost psychology. Employees who have accumulated substantial unvested equity over multiple years often remain in suboptimal roles, tolerating unsatisfactory working conditions or limited growth prospects because departing would forfeit years of accumulated equity value. Cross-company mobility suffers particularly when employees contemplate moving from startups offering equity compensation to established multinational corporations providing primarily cash compensation, as such transitions trigger immediate tax events without providing liquidity to fund the obligation.³⁴

²⁹ Ashutosh Bisht, *supra* note 3.

³⁰ *Id.*

³¹ *Id.*

³² Times of India, *supra* note 6; Ascentium, *supra* note 2.

³³ Times of India, *supra* note 6.

³⁴ See iQOO Community India, Govt Mulls ESOP Tax Relief, but Liquidity Risks Still Haunt Startup Employees (Jan. 10, 2026), <https://community.iqoo.com/in/thread/133526>.

From a hiring competitiveness perspective, startups face severe disadvantages. Cash-constrained early-stage companies cannot match the salary packages offered by established technology firms or multinational corporations, relying instead on equity upside to attract talent.³⁵ However, tax uncertainty and the liquidity-taxation mismatch cause prospective employees to heavily discount the perceived value of ESOP grants, reducing their effectiveness as recruitment tools.³⁶ While the post-2020 introduction of Section 80-IAC deferral represented an improvement over the pre-2020 regime of immediate tax withholding at exercise, mobility metrics show limited improvement given the cessation trigger's continued constraining effect.³⁷

C. Behavioral Distortions

The tax regime induces suboptimal exercise behavior patterns. Employees frequently delay exercising options despite economic rationality suggesting earlier exercise would maximize value, because they fear triggering unaffordable tax bills on illiquid gains.³⁸ This risk-averse behavior can result in forfeited value if the company's valuation subsequently declines or if employment terminates before exercise, causing options to lapse

Valuation disputes create perverse incentives. Employees and employers share an interest in understating fair market value to minimize perquisite taxation, while simultaneously needing to maximize valuations for fundraising purposes and cap table management.³⁹ This tension generates inconsistent valuation approaches and exposes both parties to tax authority scrutiny. The phenomenon of "paper millionaires," employees with high net worth reflected on capitalization tables but no accessible liquid wealth, breeds frustration and undermines the motivational purpose ESOPs are intended to serve.⁴⁰

D. Founder-Employee Misalignment

Perhaps most problematically, the current regime creates asymmetric tax treatment between founders and employees despite both groups contributing to value creation. Founders typically hold shares from incorporation and benefit from capital gains treatment upon sale, with long-

³⁵ Ascentium, *supra* note 2.

³⁶ See TreeLife, *ESOP Taxation in India: A Complete Guide (2025)* (Oct. 2, 2025), <https://treelife.in/taxation/esop-taxation-in-india/>.

³⁷ Times of India, *supra* note 6.

³⁸ Court Kutchehry, *supra* note 5.

³⁹ *Id.*

⁴⁰ Ashutosh Bisht, *supra* note 3; iQOO Community India, *supra* note 34.

term capital gains taxed at 20% or lower depending on classification.⁴¹ Employees, conversely, face salary taxation at marginal rates up to 30% or higher at exercise, followed by capital gains tax on subsequent appreciation.⁴² This differential treatment generates perceptions of inequity that undermine team cohesion and the shared-success narrative essential to startup cultures.

High employee turnover driven by tax-induced mobility constraints forces companies to repeatedly grant new ESOPs to replacement hires, exhausting the ESOP pool allocated at incorporation and requiring board approval for pool expansion, which dilutes existing shareholders including earlier employees.⁴³ This dynamic creates a negative feedback loop where tax policy indirectly increases dilution and reduces per-employee equity value.

IV. COMPARATIVE ANALYSIS: LESSONS FROM US, UK & ISRAEL

International jurisdictions with mature technology ecosystems have adopted ESOP taxation frameworks that prioritize deferral of tax liability until liquidity events, recognizing that taxing illiquid paper gains undermines equity compensation objectives. This section examines three instructive models: the United States' dual framework, the United Kingdom's startup-specific schemes, and Israel's comprehensive capital gains approach.

A. United States: ISO/NSO Dual Framework

The United States distinguishes between Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NSOs), offering meaningfully different tax treatments.⁴⁴ ISOs, designed to incentivize employee ownership, permit complete deferral of ordinary income taxation until sale, provided the employee satisfies holding period requirements of two years from grant and one year from exercise.⁴⁵ When these conditions are met, the entire gain from strike price to sale price receives favorable long-term capital gains treatment at federal rates ranging from 0% to 20%, substantially lower than ordinary income rates reaching 37%.⁴⁶ However, ISOs carry Alternative Minimum Tax complexity, as the spread between fair market value and exercise price at exercise may trigger AMT liability, though this can be recovered through AMT credit

⁴¹ Court Kutchehry, *supra* note 5.

⁴² *Id.*

⁴³ Ascentium, *supra* note 2.

⁴⁴ Nordic HQ, *supra* note 8.

⁴⁵ *Id.*

⁴⁶ *Id.*

mechanisms in subsequent years.⁴⁷ ISOs face a \$100,000 annual exercise limit based on fair market value at grant, alongside strict eligibility criteria regarding employee status and holding requirements.⁴⁸

NSOs offer greater flexibility without holding period requirements but subject employees to ordinary income taxation at exercise on the spread between fair market value and strike price, similar to India's current regime.⁴⁹ The critical distinction lies in employer tax treatment: NSOs provide companies with corresponding tax deductions for the compensation expense, creating an economic offset absent in the ISO structure.⁵⁰

A particularly valuable feature unavailable in Indian law is the Section 83(b) election, which permits employees to elect taxation at the grant date when fair market value typically equals strike price, thereby avoiding future perquisite taxation as the stock appreciates.⁵¹ While this election requires upfront tax payment and carries forfeiture risk if employment terminates before vesting, it exemplifies policy flexibility that accommodates diverse employee risk preferences.

The ISO framework demonstrates that tax deferral until liquidity events is administratively feasible at scale. The complexity introduced by AMT provisions and holding period tracking proves manageable through established Internal Revenue Code Section 409A valuation standards that provide safe harbor compliance pathways and reduce valuation disputes.⁵²

B. United Kingdom: EMI & CSOP Schemes

The United Kingdom has developed startup-specific ESOP regimes that eliminate exercise taxation entirely. The Enterprise Management Incentives (EMI) scheme, targeted at companies with gross assets below £30 million and fewer than 250 employees, represents the most generous treatment.⁵³ Qualifying employees pay no income tax or National Insurance contributions at exercise; taxation occurs only at sale as capital gains taxed at 10% to 20% depending on total gains and applicable reliefs.⁵⁴ EMI permits up to £250,000 in option value

⁴⁷ Id.

⁴⁸ Id.

⁴⁹ Id.

⁵⁰ Id.

⁵¹ See I.R.C. § 83(b) (2024).

⁵² Nordic HQ, *supra* note 8.

⁵³ Id.

⁵⁴ Id.

per employee, with additional relief available through Business Asset Disposal Relief (formerly Entrepreneurs' Relief) that reduces the capital gains rate to 10% on qualifying disposals.⁵⁵

The Company Share Option Plan (CSOP) serves as a broader scheme with a £60,000 per-employee limit, increased from £30,000 in April 2023.⁵⁶ CSOP similarly eliminates income tax at exercise for options held at least three years from grant, with only capital gains tax applying at sale.⁵⁷

The United Kingdom's approach offers several advantages translatable to the Indian context. First, tax-free exercise completely eliminates the liquidity crisis that defines India's current regime. Second, startup-specific schemes explicitly recognize that growth companies face different constraints than established corporations, tailoring eligibility and limits accordingly. Third, established valuation frameworks governed by Her Majesty's Revenue and Customs provide clarity and reduce compliance disputes, creating predictability that benefits both employers and employees.⁵⁸

The EMI model particularly aligns with Indian policy objectives around startup promotion. By restricting eligibility to smaller, growth-stage companies, the regime targets tax benefits where they generate maximum economic impact on job creation and innovation without extending preferential treatment to mature corporations with different compensation dynamics.

C. Israel: Capital Gains Approach

Israel's Section 102 trust structure represents perhaps the most comprehensive departure from perquisite taxation models. Under Section 102, employees face zero taxation at exercise; the entire gain from strike price to sale price is taxed as capital gains at a flat 25% rate upon sale, provided shares are held through a qualifying trustee structure for a minimum two-year period from grant.⁵⁹ This holding period commences at grant, not exercise, providing additional flexibility compared to US ISO requirements.⁶⁰ Critically, employers bear no tax withholding

⁵⁵ Id.

⁵⁶ Id.

⁵⁷ Id.

⁵⁸ Id.

⁵⁹ Id.

⁶⁰ Id.

or reporting obligations related to the options, substantially reducing administrative compliance burdens.⁶¹

Eligibility requires that the employee hold less than 10% of company shares, preventing controlling shareholders from exploiting the preferential regime, and the structure accepts Section 409A valuations used for US reporting, creating harmonization for companies operating across jurisdictions.⁶² The trust mechanism ensures compliance while protecting employee interests, with the trustee holding shares during the minimum period before permitting withdrawal or sale.

Israel's tech ecosystem success is frequently attributed in part to this favorable ESOP regime, which removes tax considerations as barriers to equity acceptance and exercise.⁶³ The simple, predictable structure, with a single flat capital gains rate and clear holding requirements, minimizes planning complexity and valuation disputes. By completely eliminating dual taxation and the liquidity-taxation mismatch, Section 102 exemplifies how tax policy can actively enable rather than hinder equity compensation.

D. Comparative Synthesis

The table below summarizes key distinctions across jurisdictions:

Jurisdiction	Tax at Exercise	Tax at Sale	Maximum Rate	Key Advantage
India (current)	Salary (30%+) on FMV-strike spread	CG on sale-FMV	~42% (salary+cess)	Limited deferral (eligible startups only) ⁶⁴
US (ISO)	Nil (AMT potential)	CG (0-20%) on sale-strike	20% (federal)	Full deferral; established valuation standards ⁶⁵
UK (EMI)	Nil	CGT (10-20%) on sale-strike	10% (with BADR)	Tax-free exercise; startup-specific ⁶⁶

⁶¹ Id.

⁶² Id.

⁶³ Id.

⁶⁴ Times of India, supra note 6; Income Tax Act, 1961, § 80-IAC, No. 43 of 1961, India Code (2024).

⁶⁵ Nordic HQ, supra note 8.

⁶⁶ Id.

Israel (Section 102)	Nil	25% flat CG on sale-strike	25%	Simple; no employer obligation; single tax event ⁶⁷
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All three comparator jurisdictions defer or eliminate exercise taxation, recognizing that illiquid equity should not trigger immediate cash tax obligations. India stands as an outlier in maintaining perquisite taxation at exercise for the majority of employees, with deferral relief limited to a narrow subset of eligible startup employees subject to mobility-constraining cessation triggers. The international consensus supports the proposition that alternative tax treatments better align incentives, administrative feasibility, and revenue collection with the practical realities of equity compensation in growth companies.

V. ALTERNATIVE TAX TREATMENTS: PROPOSAL & MODELING

Drawing on comparative insights and economic analysis of current regime failures, this section proposes three alternative tax treatment models for Indian ESOPs, evaluating their design features, economic impacts, revenue implications, and implementation feasibility.

A. Model 1: Full Deferral to Sale (Israel-Inspired)

The most comprehensive reform would eliminate perquisite taxation at exercise for all startup employees, not merely those meeting Section 80-IAC eligibility criteria, and consolidate taxation at the point of sale. Under this model, the entire gain from exercise price to sale price would be taxed as capital gains, with long-term capital gains treatment available if the holding period between grant or exercise and sale exceeds 24 months.⁶⁸

Economic modeling demonstrates substantial employee benefit. Using the earlier scenario where an employee exercises 10,000 options at ₹10 strike price with ₹500 fair market value and subsequently sells at ₹600, the current regime imposes approximately ₹15 lakh in perquisite tax at exercise plus ₹3 lakh in capital gains tax at sale, totaling ₹18 lakh on a ₹59 lakh total gain.⁶⁹ The proposed model would levy only ₹11.8 lakh as long-term capital gains at

⁶⁷ Id.

⁶⁸ Cf. Nordic HQ, supra note 8 (describing Israeli Section 102 capital gains treatment).

⁶⁹ Court Kutchehry, supra note 5.

20% on the ₹59 lakh gain, generating ₹6.2 lakh in net tax savings while eliminating the pre-liquidity cash outflow crisis.⁷⁰

Revenue implications require careful analysis. While short-term revenue collection would decline due to deferred taxation, several offsetting factors mitigate leakage concerns. First, higher exercise rates resulting from eliminated tax barriers would expand the taxable base, as employees who currently forgo exercise due to tax fears would participate more actively. Second, increased startup formation and survival rates driven by improved hiring competitiveness would generate broader tax revenues through corporate taxation, dividend taxation, and increased employee income tax from a growing sector. Third, the expanded base of successful exits would eventually produce higher aggregate collections despite lower per-transaction rates.

Anti-abuse safeguards would prove essential. A minimum holding period requirement would prevent short-term trading strategies designed purely for tax arbitrage. Related-party transaction scrutiny would guard against collusive underpricing between founders and employee family members. Exit taxation provisions modeled on Section 115JC could impose deemed exercise taxation upon change of tax residency to prevent employees from expatriating post-exercise to avoid Indian taxation entirely. Finally, tying preferential treatment to startup recognition criteria would prevent established corporations from exploiting a regime designed for growth companies.⁷¹

B. Model 2: Safe Harbor Valuation + Tax Credit

A more moderate approach would retain the two-stage taxation structure while addressing double taxation and valuation uncertainty. This model would introduce statutory safe harbor valuation formulae, such as revenue multiples or prescribed discounted cash flow parameters, that taxpayers could elect to apply in lieu of merchant banker valuations, reducing compliance costs and dispute potential.⁷² Simultaneously, perquisite tax paid at exercise would be eligible as a credit against capital gains tax liability upon sale, modeled on the United Kingdom's CSOP

⁷⁰ See Income Tax Act, 1961, § 112, No. 43 of 1961, India Code (2024) (prescribing 20% rate for long-term capital gains on unlisted equity).

⁷¹ Cf. Times of India, *supra* note 6 (discussing government deliberations on ESOP reform).

⁷² See Court Kutchehry, *supra* note 5 (noting current valuation disputes).

structure.⁷³

This approach offers revenue neutrality as a primary advantage. The government collects tax earlier with subsequent credit adjustment at sale, maintaining cash flow timing while eliminating the perception and partial reality of double taxation. Employees retain some liquidity pressure at exercise, which may promote exercise discipline and prevent purely speculative holdings, while avoiding the full double taxation burden. Valuation certainty through safe harbor formulae would substantially reduce litigation and assessment disputes that currently burden both taxpayers and tax administration.⁷⁴

However, Model 2 provides minimal improvement to the mobility crisis. The cessation trigger would likely remain, and employees would still face initial cash flow challenges at exercise, albeit with the knowledge that taxes paid would offset future liabilities.

C. Model 3: Expanded Deferral with Modified Triggers

A targeted reform would expand Section 80-IAC eligibility to a broader startup definition, encompassing companies up to ten years from incorporation with turnover limits of ₹500 crore, substantially increasing the population of eligible employees.⁷⁵ Most critically, this model would eliminate the cessation-of-employment trigger, deferring taxation only until share sale or a seven-year maximum period from exercise, whichever occurs first.⁷⁶ An innovative portability mechanism could permit transferring deferred tax liability to a new employer's ESOP scheme when employees change jobs within the startup ecosystem, maintaining deferral across career transitions.

This approach directly addresses the mobility crisis by decoupling tax consequences from employment continuity. Employees could pursue career advancement without triggering immediate tax liabilities, restoring ESOPs to their intended incentive function rather than retention trap. The seven-year maximum cap balances revenue concerns by ensuring eventual collection while providing meaningful deferral during the typical period before liquidity events. Implementation would require only targeted amendments to Section 80-IAC rather than

⁷³ See Nordic HQ, *supra* note 8 (describing UK CSOP structure).

⁷⁴ TaxSutra, *supra* note 24 (discussing High Court valuation controversies).

⁷⁵ Cf. Income Tax Act, 1961, § 80-IAC, No. 43 of 1961, India Code (2024) (current eligibility criteria).

⁷⁶ Times of India, *supra* note 6; Ascentium, *supra* note 2.

comprehensive structural overhaul of the Income Tax Act, improving legislative feasibility.⁷⁷

D. Comparative Policy Assessment

Model 1 offers maximum employee benefit and strongest mobility improvement but carries highest revenue risk and requires most substantial legislative reform. Model 2 achieves revenue neutrality and reduces valuation disputes but provides limited mobility enhancement. Model 3 represents a balanced middle path, preserving the existing structural framework while surgically correcting the cessation trigger and eligibility constraints that generate the most severe practical problems. From a policy implementation perspective, Model 3 could serve as an interim reform while longer-term structural changes contemplated in Model 1 undergo extended stakeholder consultation and revenue impact analysis.

VI. COUNTERARGUMENTS & REVENUE CONCERNS

Any proposal to defer or eliminate exercise taxation inevitably confronts objections centered on revenue protection, valuation integrity, and tax policy neutrality principles. These concerns merit serious engagement, though careful policy design can adequately address each challenge.

A. Tax Leakage Risks

The primary governmental concern involves employees exercising options during Indian tax residency, benefiting from deferral, and subsequently relocating abroad before sale to avoid taxation entirely. This leakage risk appears substantial given India's significant professional emigration to higher-income jurisdictions.⁷⁸

However, multiple safeguards can address this concern without abandoning reform. Exit taxation provisions analogous to those in Section 115JC could impose deemed exercise or sale taxation upon change of tax residency status, treating expatriation as a taxable event that crystallizes deferred liabilities.⁷⁹ Double Taxation Avoidance Agreement renegotiation could ensure India's source country taxing rights over equity compensation earned during Indian residency, similar to provisions in treaties governing pension taxation. Importantly, Israel maintains high tax compliance despite offering the most generous ESOP regime globally,

⁷⁷ See Finance Act, 2020, § 80-IAC (demonstrating legislative precedent for targeted ESOP reform).

⁷⁸ See generally Ashutosh Bisht, *supra* note 3 (discussing employee emigration patterns).

⁷⁹ Cf. Income Tax Act, 1961, § 115JC, No. 43 of 1961, India Code (2024).

demonstrating that favorable treatment need not produce unacceptable leakage when accompanied by appropriate enforcement mechanisms.⁸⁰

B. Valuation Manipulation

Critics argue that deferral incentivizes employees and employers to collude in understating fair market value at exercise, reducing the ultimate tax base when sale occurs years later with less documentation and audit trail.⁸¹ This concern carries particular weight given India's history of transfer pricing disputes and related-party transaction scrutiny.

Existing safeguards substantially mitigate this risk. The mandatory merchant banker valuation requirement for unlisted companies already imposes professional accountability and regulatory oversight on valuation determinations.⁸² Safe harbor valuation formulae, if adopted under Model 2, would further reduce discretion and manipulation opportunities by prescribing objective metrics. Penalties for egregious undervaluation could be enhanced to create meaningful deterrence. Most fundamentally, taxation at sale captures true economic value regardless of exercise valuation, as the sale price reflects arm's length market determination rather than internal estimates. Any understatement of fair market value at exercise merely shifts the component taxed as perquisite versus capital gains, without eliminating taxation of the total economic gain.⁸³

C. Equity vs. Cash Compensation Neutrality

Tax policy purists contend that preferential ESOP treatment distorts employer compensation decisions, artificially incentivizing equity over cash compensation contrary to neutrality principles that should allow business rather than tax considerations to drive such choices.⁸⁴

This objection misapprehends both empirical reality and policy objectives. Compensation structure in startups is driven primarily by business model constraints, specifically severe cash limitations in early-stage companies, rather than tax arbitrage opportunities.⁸⁵ Cash compensation already enjoys certain preferential treatment through standard deductions and

⁸⁰ Nordic HQ, *supra* note 8.

⁸¹ Court Kutchehry, *supra* note 5.

⁸² *Id.*; Income Tax Department, *supra* note 13.

⁸³ Court Kutchehry, *supra* note 5.

⁸⁴ See generally TreeLife, *supra* note 36.

⁸⁵ Ascentium, *supra* note 2.

effectively lower rates for employees in lower income brackets, so perfect neutrality does not characterize the existing regime. More fundamentally, entrepreneurship promotion and startup ecosystem development constitute explicit policy goals embedded throughout Indian legislation, from Startup India recognition to Section 80-IAC itself.⁸⁶ Tax neutrality, while generally desirable, appropriately yields to targeted incentive structures when advancing defined economic development objectives.

D. Revenue Projections

The ultimate fiscal concern involves quantifying revenue impact. Precise projections require government access to comprehensive ESOP exercise data currently unavailable to external researchers. However, dynamic scoring methodologies suggest revenue impact may prove substantially less negative than static analysis implies. Increased startup success rates driven by improved hiring competitiveness expand future corporate income tax collections, dividend tax revenue, and employee income tax from a growing sectoral base. The United Kingdom and Israel both experienced net tax revenue increases following ESOP regime liberalization, as broader ecosystem growth more than offset per-transaction rate reductions.⁸⁷

A phased implementation approach could permit empirical evaluation before full rollout. Initial application to companies below specified size thresholds would limit revenue exposure while generating data on exercise rate changes, mobility patterns, and eventual collection outcomes that could inform subsequent expansion decisions.

VII. CONCLUSION & RECOMMENDATIONS

India's current ESOP taxation regime creates a structural mismatch between tax liability and liquidity that fundamentally undermines equity compensation as a talent incentive tool. By imposing perquisite taxation at exercise on illiquid paper gains, the framework forces employees to fund substantial tax obligations from personal resources years before realizing any cash from their equity holdings.⁸⁸ Section 80-IAC's deferral provision, while acknowledging the problem, operates with such narrow eligibility and a cessation-of-employment trigger that transforms ESOPs from incentives into golden handcuffs, constraining

⁸⁶ See Ministry of Commerce and Industry, *supra* note 1; Income Tax Act, 1961, § 80-IAC, No. 43 of 1961, India Code (2024).

⁸⁷ Nordic HQ, *supra* note 8.

⁸⁸ Court Kutchehry, *supra* note 5; Times of India, *supra* note 6.

rather than enabling career mobility.⁸⁹ Comparative analysis demonstrates that the United States, United Kingdom, and Israel have successfully implemented frameworks that defer or eliminate exercise taxation, recognizing that illiquid equity should not trigger immediate cash tax obligations.⁹⁰

Policy Recommendations

Immediate Legislative Priority:

Parliament should adopt Model 1's full deferral approach for recognized startups up to ten years from incorporation, eliminating perquisite taxation at exercise and consolidating tax liability at sale as capital gains. This reform should eliminate the cessation-of-employment trigger, permitting employees to change jobs without triggering deferred liabilities and restoring genuine mobility to the startup talent market.⁹¹ Implementation should include safe harbor valuation formulae modeled on US Section 409A standards to reduce compliance burdens and valuation disputes that currently plague the regime.⁹²

Medium-Term Considerations:

For mature technology companies beyond startup classification, introduce Model 2's tax credit system where perquisite tax paid at exercise offsets capital gains liability at sale, eliminating double taxation without requiring structural overhaul. Consider adopting a Section 83(b)-type early taxation election mechanism for sophisticated employees willing to accept upfront tax in exchange for locking in valuation at grant when fair market value equals strike price, providing optionality that accommodates diverse risk preferences.⁹³ Address founder-employee tax asymmetry by harmonizing treatment or providing explicit justification for differential rates.

Institutional Requirements:

The Supreme Court should resolve or the Central Board of Direct Taxes should issue comprehensive clarificatory circulars addressing timing controversies regarding whether perquisite arises at exercise or allotment, as well as characterization questions raised by

⁸⁹ Times of India, *supra* note 6; Ascentium, *supra* note 2.

⁹⁰ Nordic HQ, *supra* note 8.

⁹¹ Cf. Nordic HQ, *supra* note 8 (describing Israeli full deferral model).

⁹² *Id.* (discussing US Section 409A valuation standards).

⁹³ See I.R.C. § 83(b) (2024).

divergent High Court rulings.⁹⁴ Startup India certification processes require streamlining to expand eligibility without creating administrative bottlenecks. The government should commit to annual review of revenue impact data, exercise rate changes, and mobility metrics to permit evidence-based policy adjustments.

Concluding Observation

Tax policy constitutes a critical tool in India's broader strategy to build a globally competitive startup ecosystem capable of attracting and retaining world-class talent.⁹⁵ The current regime, designed when ESOPs represented a marginal compensation form, no longer serves an economy where equity participation has become central to startup value propositions. Alternative tax treatments that defer liability until liquidity events better align government revenue interests with employee welfare and startup growth objectives, without creating meaningful leakage risks when accompanied by appropriate safeguards. International experience demonstrates both the feasibility and benefits of such reforms. The salient question is not whether change is necessary, but rather how swiftly Indian policymakers will act to prevent continued talent migration and competitive disadvantage in an increasingly globalized innovation economy where jurisdictional tax treatment materially influences location decisions for both companies and skilled professionals.⁹⁶

⁹⁴ TaxSutra, *supra* note 24; Court Kutchehry, *supra* note 5.

⁹⁵ Ministry of Commerce and Industry, *supra* note 1; Ascentium, *supra* note 2.

⁹⁶ Times of India, *supra* note 6; Ashutosh Bisht, *supra* note 3; iQOO Community India, *supra* note 34.