Employee Stock Option Plan (ESOP) – An Introduction

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1. Introduction

Employee stock option plan (ESOP) is an employee-ownership plan that provides an option with an opportunity to company's workforce to gain ownership interest in the company. It develops the sense of belongingness between the workforce and company. In an ESOP, companies provide their employees with stock options, often at no up-front cost to the employees. ESOP shares, however, are part of employees' remuneration for work performed. Shares are allocated to employees and may be held in an ESOP trust until the employee retires or leaves the company. This is one of retirement plans created by the corporations for their work force. These shares are traded at market.

Across world there are large corporations with majority employee-shareholding. These corporations are known as employee-owned corporations. Such organizations are similar to worker cooperatives, but unlike cooperatives, control of the company's capital is not necessarily evenly distributed. Compared with cooperatives, ESOP-centered corporations allow the company executives to have greater flexibility in governing and managing the corporation. Most corporations, however, utilize stock ownership plans as a form of in-kind benefit, as a way to prevent hostile takeovers, or to maintain a specific corporate culture. These plans generally have a maximum cap on individual employee holdings.

2. Worldwide scenario:

US: In the mid-19th century, as the United States transitioned to an industrial economy, national corporations like Procter & Gamble, Railway Express, Sears & Roebuck, and others recognized that someone could work for the companies for 20 plus years, reach an old age, and then have no income after they could no longer work. The great visionary leaders of those 19th century companies decided to set aside stock in the company that would be given to employees when they retired.

ESOPs were developed as a way to encourage capital expansion and economic equality. Many of the early visionaries of ESOPs believed that capitalism's viability depended upon continued growth and that there was no better way for economies to grow than by distributing the benefits of that growth to the workforce.

In 2001, the United States Congress enacted Internal Revenue Code section 409(p), which essentially requires that 'S' corporation to ensure ESOP benefits shared equitably by investors and workers as well. This enabled that the ESOP are allotted to everyone from the receptionist to the CFO. In the early 20th century, when the United States imposed an

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income tax on all citizens, one of the biggest debates was about how to treat stock set aside for an employee by his employer under the new US income tax laws.

UK: ESOPs became widespread for a short period in the UK under the government of Margaret Thatcher, particularly following the Transport Act 1985, which deregulated and then privatised the bus services. Councils seeking to protect workers ensured that employees accessed shares when privatisation taken place, but employee owners soon lost their shares as they were bought up and bus companies were taken over. The disappearance of stock plans was dramatic.

In July 2012, the Department for Business Innovation and Skill, UK, published a report called, "The Employee Ownership Advantage, Benefits and Consequences" This report listed several major advantages of employee ownership including stronger long-term focus; increased employee representation at board level; and greater preference for internal growth. The report also highlighted that employee owned businesses face greater problems when it comes to raising capital and dealing with regulatory requirements.

Australia: In Australia the survival of ESOP plans of any company purely depends on taxation policy of Govt. on ESOPs. Majority of cases the ESOPS are granted by the start-up companies as a part remuneration ESOP. As these start-up companies which are not cash rich are not able attract and retain the technical talent and can't match the salaries as are paid by multinational companies to technically talented workforce, the companies are ready to provide the ESOPs as part of remuneration to employees which would be cashless by giving an equity rather paying capital. The income tax policy imposes tax at time of exercising the option rather at the time of selling the shares. It has become major concern to employee to accept the ESOPs in these start-up companies. It's not very attractive for the employee if they are forced to pay tax on something that may have never reached its proposed value. In Australia, start-up Companies faced a lot of challenges in attracting technical talent.

Start-up Companies: After review the situation in July 2014 (effective from July 2015), the govt. reformed taxation system for ESOP. Eligible start-ups are recognized. They will be allowed to issue shares to employees at up to 15 per cent and issue options under advantageous conditions. Shares and options that were allocated at a discount shall also not be subject to up-front taxation, so long as they are held by the employee for at least three years. Importantly, the options/shares will only be taxed at the time the shares are sold. This means that employees only have to pay tax when they actually receive value. Start-up companies will now be able to attract talent and retain employees by paying them with equity rather than vital capital needed to grow the business.

Singapore: Employee Share Option (ESOP) and Employee Share Ownership (ESOW) are two type of employee share option plans available at Singapore. ESOP plans give the employee the rights to purchase shares in the company at a specific pre-determined price within a time frame. An employee who is granted share options by an employer will be taxed on any gains or profits arising from the exercise of the share option. ESOW plans allow an employee of a company to own or purchase shares in the company or in its parent company. They include share awards and other similar forms of employee share purchase plans (excluding

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phantom shares and share appreciation rights). An employee who is granted ESOW by the employer is subject to tax on any gains or profits when the ESOW plan vests on the employee.

India: There are two types of schemes used by Indian Companies to attract and retain talented work force. One is Employee stock options scheme. Another one is Employee Stock Purchases Scheme. These concepts were introduced to the companies around 25 years ago by new generation information technology driven companies. These information technology companies started giving ESOPs to attract and retain young talented. In many cases these companies offered their ESOPs to all kinds of employee. Some companies offered to the key and senior management team who drive the company performance. There are various governing legislatives such as the Companies Act, 2013, SEBI Regulations, Income Tax and FEMA. As per present income tax rules, at time of exercising of the options the notional benefits (difference between exercise price and market value) out of exercising are considered as perquisites which are part of salary of employee. The companies are required to deduct withholding tax (TDS) on perquisites including benefits of ESOPs.

3. Various types of employee share based schemes across the globe

3.1 Employee stock purchase plan: It is direct purchase plan. This simply allows employees to buy shares in the company with their own, usually after-tax, money. There are special tax-qualified plans, however, that allow employees to buy stock either at a discount or with matching shares from the company. For instance, in the U.S., employees can put aside after-tax pay over some period of time (typically 6–12 months) then use the accumulated funds to buy shares at up to a 15% discount at either the price at the time of purchase or the time when they started putting aside the money, whichever is lower. In the U.K. employee purchases can be matched directly by the company.

3.2. Employee Stock options: Stock options give employees the right to buy a number of shares at a price fixed at grant for a defined number of years into the future. Options, and all the plans listed below, can be given to any employee under whatever rules the company creates, with limited exceptions in various countries.

3.3 Restricted stock: Restricted stock and its close relative restricted stock units give employees the right to acquire or receive shares, by gift or purchase, once certain restrictions, such as working a certain number of years or meeting a performance target, are met.

3.4 Phantom stock: Phantom stock pays a future cash bonus equal to the value of a certain number of shares.

3.5 Stock appreciation rights: Stock appreciation rights provide the right to the increase in the value of a designated number of shares, usually paid in cash but occasionally settled in shares (this is called a “stock–settled” SAR).

3.6 Cooperatives: Worker cooperatives are very different from the above mechanisms. They require members to join. Each worker-member buys a membership interest at a fixed price,

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or buys a share. Only workers can be members, but cooperative scan hire non-worker owners. Each member gets one vote.

4. Benefits of ESOPs

4.1 To the Company: A good and well-structured ESOPs may give lot of benefits to the companies. Some of benefits are illustrated below for understanding:

- Attracting and retaining the talented pool of workforce for longer period in employment.

- The continuing in the improvement of performance of employees

- Saving of capital of the Company by issuing equity

- Reduction in labour turnover and cost of the hiring employees,

- Reduction in fixed outlays of salary components

4.2 To the Employees: In well-structured and well-traded stocks, the ESOPs can be considered as good investment model to employees as compared to regular traditional options of investments available. The return on investment would be always high, as the investment is generally made at concessional rate when compared to the market price. Some initial out lay from employee would be even zero in case of cash-less options. Face value and entire appreciation of shares will be income to the employee.

5. Disadvantages of ESOPs

5.1 Company: As far as the company is concerned, it is a major challenging task to differentiate and identify the performers and non-performers of workforce in the same hierarchy. It may lead to unrest in the non-performers. Negativity may be developed among the workforce. Morale may come down. The co-ordination and co-operation among the workforce may be bit of challenge. The dilution of equity stake by the promoters, collaborators, general shareholders to accommodate the ESOP at discounted price sometimes may have far reaching financial consequence. The collaborators, technology partners may not agree for the same. To overcome above concerns, the management is required to visualize all challenges, pros and cons associated to ESOP, if required, engage management, legal and taxation experts and draw a crystal clear policy, structuring and implementation of ESOPs with an objective to promote performance of the company with sustainability in mind. The size and pricing, risk involved, eligibility of employees, various hierarchies of employees covered, tax implication to company and employees, the policy of government on ESOPs –manner, formation of trustee, or direct administration of ESOPs, financing of ESOP if required etc. shall be decided carefully.

5.2 Employees: As far as the employees are concerned, major disadvantage witnessed across the globe is taxation of ESOPs at exercising stage rather selling stage by government on notional income concept, where there is no inflow the hands of the employee to meet the expenses of taxation. Some of companies are even adopting policy of post lock-in-period of shares after allotment. The quantum of benefits arising out of ESOP shares is purely depending upon the time of exercising, marketing conditions at time of selling, performance

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of stock of the company at market. Tradability is an issue in case of unlisted company as there will not be any market to sell shares. Finding buyers for shares would be a difficult task. Sometimes the management may not agree for selling of shares to outsiders. The situation will be further worsened if employee after leaving the company wishes to sale as he shall not be in a position to negotiate the price and other terms with management. At times the circumstances may not permit the company to buy back the ESOP shares. The shares may need to be sold at a price determined by the company. In order to overcome some of the disadvantages, the employee needs to demonstrate care and diligence, keep in mind, type of company which he would like to serve, type of industry, listed or unlisted, if listed performance of stock price, existing performance of ESOP scheme etc., what are other exit options available in case of unlisted company, culture of the company, good negotiation with company for balanced structure of remuneration package with fixed and variable components, ESOPs etc. time to exercise the options vested, time to sell the shares etc.

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