"ESOP's"

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DEFINITION

An Employee Stock Ownership Plan (ESOP) is a program that provides employees with an ownership interest in the company. It typically involves granting stock options to employees, which they can exercise after a specified vesting period to purchase shares at a predetermined price.

INTRODUCTION

Employee Stock Ownership Plans (ESOP's) have become an integral part of the corporate landscape in India, providing a powerful incentive mechanism to attract, retain, and motivate employees. Introduced as a strategic tool to align the interests of employees with those of the company and its shareholders, ESOP's allow employees to acquire ownership in the company through stock options. Governed by the Companies Act, 2013, and the SEBI (Share Based Employee Benefits) Regulations, 2014 for listed companies, ESOP's offer a structured way for employees to participate in the company's growth and success. The eligibility typically includes permanent employees and directors, excluding independent directors and promoters. Through a well-designed ESOP scheme, companies can enhance employee commitment, productivity, and loyalty, driving long-term growth and value creation. This mechanism not only fosters a sense of ownership among employees but also serves as a significant financial incentive, contributing to the overall stability and performance of the organization. For comprehensive regulatory guidelines and implementation details, companies often refer to the Ministry of Corporate Affairs and SEBI regulations.

REGULATIONS

1. **Companies Act, 2013:** Section 62(1)(b) of the Companies Act, 2013, outlines the issuance of shares to employees under a scheme of employee stock options.

2. **SEBI (Share Based Employee Benefits) Regulations, 2014:** These regulations provide detailed guidelines for listed companies on the implementation and administration of ESOP's, including eligibility criteria.

HISTORY

1. San Francisco lawyer and economist Louis O. Kelso created the first employee stock ownership plan (ESOP) in 1956 as a way to transition ownership of Peninsula Newspapers, Inc. from its two founders (both then in their 80s) to their chosen successors, the managers and employees.
2. Though not well publicized Wipro was the first Indian company in 1985, if not one of the earliest companies in India to introduce ESOP's. However, it was Infosys in the 1990s which brought ESOP's into public discourse with the large number of ESOP rupee millionaires and billionaires it created.
3. In 1990s, Income tax was a critical factor that added more sheen to the already glittering ESOP's, making it more attractive. Being exempt from tax both at the time of exercise of options and at the time of sale due to the then prevailing tax laws, the value of ESOP's doubled compared to its alternative salaries.
4. Despite this 'loophole' being plugged in early 2000's, ESOP's continue to be attractive, as the employees get the benefit of stock ownership without making any upfront investments.
5. With the accounting change that required the cost of ESOP's to be accounted which started in early 2000's, established and profitable companies did not see any obvious and explicit benefit in issuing ESOP's. However, in the start-up world ESOP has retained it preeminent position and looks well entrenched for the future.

KEY TERMS

1. **Grant:** Grant means the issue of stocks to the employees. It means informing the employee that he is eligible for ESOP.
2. **Cliff:** Cliff is the time period between the ESOP grant date and the ESOP vesting start date during which the ESOP holder cannot vest their options or gain full ownership of their shares
3. **Vesting:** Gradual process by which employees gain ownership of employer-contributed benefits over time.
4. **Exercise price:** The price at which employees can purchase shares is usually set at the time of the grant and is often lower than the market price.
5. **Exercise period:** Number of days that employees are allowed to buy the shares.
6. **Option pool:** The total number of shares reserved by the company for issuing under the ESOP.

TYPES OF ESOP's

1. **Employee Stock Option Scheme (ESOS):**

    - This is the most common type of ESOP. An employee stock option scheme (ESOS) allows an employee the opportunity to purchase company shares at a predetermined price, typically below the market value.

    - These options are typically granted as part of a compensation package and are subject to certain performance goals over a set vesting period.

    - If the employee decides to exercise their option, they will become a shareholder with full ownership rights and the ability to vote and receive dividends. However, if the employee chooses not to exercise their option, they will not receive any benefits.

2. **Employee Stock Purchase Plan (ESPP):**

    - An employee stock purchase plan (ESPP) allows employees to purchase company stock at a discounted price and gradually increase their ownership stake in the business through periodic investments. ESPP allows participation in company profits as well, in the form of dividends.

    - It is a risk-free way for employees to purchase stock, as they can invest a set amount through payroll deductions or on an annual basis and participate in a company's growth and prosperity.

3. **Restricted Stock Units (RSUs) :**

    - Restricted stock units (RSUs) are a type of ESOP that allows employees to convert RSUs into real company stocks in exchange for a certain number of years spent working for the company or when specific performance milestones are achieved.

    - Once the vesting requirements are met, the employee is entitled to receive the shares. Do note these units do not come with voting rights or dividends until the vesting period is completed. These plans are typically in place to motivate employees and allow them to contribute to the company's growth.

4. **Restricted Stock Award (RSA):**

- Restricted Stock Awards (RSA) are a type of stock-based compensation that involves the grant of a specific number of shares to an employee, subject to certain restrictions. Typically, the restrictions on RSA shares are based on the vesting period and other performance goals.

- One key difference between RSAs and Restricted Stock Units (RSUs) is with the latter, the employee does not receive any actual shares until the units vest and the restrictions on them lapse. However, both RSAs and RSUs can involve restrictions on when the employee can sell or transfer the shares, as well as other terms and conditions.

5. **Stock Appreciation Rights (SARs):**

- Stock Appreciation Rights(SARs) are a type of ESOP that allows employees to receive a payment based on the appreciation of company stock over a certain period of time. Companies can use SARs to provide employees with stock benefits without diluting their equity. On the other hand, employees can benefit from such a plan by cashing in equity gains without taking on any downside risks.

- SARs are typically granted to senior executives and other key employees as a way to align their interests with those of the company's shareholders.

6. Phantom Equity Plan (PEP):

- A Phantom Equity Plan may closely resemble a Stock Appreciation Rights Plan. A Phantom Equity Plan (PEP) is a type of ESOP that allows employees to receive a payment based on the value of the company's stock without actually owning any shares.

- PEP is an alternative to traditional employee stock option schemes, which provide employees with mock or "phantom" stock that tracks the value and performance of the company's real shares. Under this arrangement, employees do not receive physical stock certificates but rather receive a financial payout based on the appreciation of the company's shares.

STEPS FOR CREATING ESOP's

1. **Defining objectives:** Identify the primary goals for implementing the ESOP, such as attracting talent, retaining employees, and aligning their interests with the company's growth.

2. **Eligibilty criteria:** Decide on the eligibility criteria for employees, typically including full-time employees, key managerial personnel, and directors (excluding independent directors and promoters).

3. **Planning the Option Pool:** Determine the size of the option pool, which is the percentage of the company's total shares reserved for the ESOP.

4. **Creating vesting schedule:** Establish a vesting schedule, which outlines how and when employees earn their stock options. Options can vest based on tenure (e.g., annually over four years) or performance criteria.

5. **Exercise Price:** Decide the exercise price, which is the price at which employees can buy the shares. This is often set at the fair market value (FMV) at the time of the grant.

6. **Exercise Period:** Define the period within which employees must exercise their options after they vest.

7. **Independent Valuation:** For unlisted startups, obtain an independent valuation of the company to determine the fair market value of the shares. This is crucial for setting the exercise price and for tax purposes.

8. **Legal Documentation:** Draft the ESOP scheme document, which outlines the terms and conditions of the plan, including eligibility, vesting schedule, exercise price, and the procedure for exercising options.

9. **Compliance:** Ensure that the ESOP scheme complies with the Companies Act, 2013, and other relevant regulations.

10. **Board Approval:** Obtain approval from the Board of Directors for the ESOP scheme.

11. **Shareholder Approval:** Convene a General Meeting of shareholders to get their approval through a special resolution.

12. **MCA Filings:** File necessary forms with the Ministry of Corporate Affairs (MCA) such as MGT-14 (for filing the special resolution) and other relevant forms.

13. **Annual Disclosures:** Make annual disclosures in the Director's Report about the ESOP's issued and outstanding.

14. **Issue Grant Letters:** Issue grant letters to eligible employees, specifying the number of options granted, the vesting schedule, the exercise price, and other relevant details.

15. **Acceptance:** Obtain acceptance from the employees for the grant of options.

16. **Record-Keeping:** Maintain accurate records of the options granted, vested, and exercised. Use an ESOP management software or service provider if necessary.

17. **Employee Communication:** Regularly communicate with employees about the status of their options, the company's performance, and any changes to the ESOP scheme.

18. **Vesting:** Track the vesting of options as per the schedule.

19. **Exercise Process:** Facilitate the exercise of options by employees, including payment of the exercise price and issuance of shares.

20. **Compliance:** Ensure compliance with tax regulations at the time of exercise and upon eventual sale of the shares by employees.

21. **Employee Taxation:** Employees are taxed at the time of exercise (as perquisite tax) and on capital gains when they sell the shares.

22. **Company Taxation:** The company can claim a deduction for the difference between the FMV and the exercise price as an employee compensation expense, subject to certain conditions.

HOW ESOP’s WORK

1. **Establishing the ESOP trust:** When a company decides to create an esop, it initiates the process by setting up an esop trust. This trust acts as the custodian of the company’s shares on behalf of its employees. The company can contribute shares of its stock to the trust. These contributions are typically tax- deductible, up to certain limits, offering a financial incentive for the company to adopt an ESOP:

2. **Share allocation:** Once the ESOP trust is established and funded, the next step is to allocate the shares to individual employee accounts. The allocation can be determined using various formulas, with the most common ones based on factors such as compensation, years of service, or a combination of both. This ensures that employees receive shares that reflect their contributions and tenure within the organisation.

3. **Vesting:** To gain full ownership of the allocated shares, employees must go through a vesting period. Vesting refers to the process of earning rights to the shares over time, typically based on their seniority within the company. The vesting period can be immediate, or it can be a gradual process that spans several years.

4. **Employee Participation:** New employees usually become eligible to participate in the ESOP and receive share allocations after completing a minimum service requirement. This encourages employee retention and ensures that those who are genuinely commited to the company’s success are the ones who benefit from ESOP.

5. **Managing share repurchases:** In cases where long standing employees are leaving the company, and the share price has substantially appreciated. The company must ensure that it has sufficient funds to cover all the share repurchases. Proper financial planning and liquidity management are essential to meet these repurchase obligations.

DISADVANTAGES OF ESOP's

1. ESOP's become slightly messy if we give it to wrong employee.

2. From employees perspective esop's may not workout if it doesn't give any returns so they should be careful while selecting it.

3. Taxation at Multiple Stages: In India, employees are taxed twice on ESOP's—first at the time of exercising the options (as a perquisite under salary income) and later when they sell the shares (as capital gains). This can lead to significant tax liabilities, particularly if the company's shares are illiquid or their value decreases after exercise.

4. Uncertainty in Valuation: The valuation of shares, especially in unlisted companies, can be challenging and subject to scrutiny by tax authorities, potentially leading to disputes or additional tax burdens.

5. Limited Market for Shares: Liquidity issue.

6. Dependence on Company's Performance

7. Impact on Existing Shareholders: Dilution of ownership.

8. Complex Decision-Making**:** As more employees become shareholders.

9. Setting Up and Managing ESOP's: Costly

WHEN DOES ESOP's PLAN BECOME SUCCESSFUL:

1. Early implementation: Benefit of aggressive growth.

2. Broad based plans - Ownership culture deep into the organisation.

3. Predictable Liquidity Event – It will help employee gain confidence in ESOP's .

4. Transparent ESOP policies – Helps employee have clarity on the topic.

5. Different structure of grants at different level/stage – Different formulas and techniques are needed for growing business.

TYPES OF VESTING IN INDIA

1. **Time-based Vesting:** Employees gain ownership of their shares or options gradually over a specified period.

    - **Cliff Vesting:** Employees receive full ownership of their shares or options after completing a specific period of continuous service (e.g., 3 years). There is no partial vesting before the cliff period.

    - **Graded Vesting:** Employees earn a portion of their shares or options incrementally over time (e.g., 25% per year over 4 years).

2. **Performance-based Vesting:** Vesting depends on the achievement of specific performance goals or milestones set by the company.

    - **Company Performance Goals:** Vesting is tied to the company's overall performance metrics, such as revenue targets, profit margins, or market share.

    - **Individual Performance Goals:** Vesting is linked to the employee's personal performance metrics, such as sales targets, project completion, or performance appraisals.

3. **Hybrid Vesting:** A combination of time-based and performance-based vesting criteria.

    - Eg: An employee might receive stock options that vest over a four-year period (time-based) but only if certain company performance targets are met (performance-based).

4. **Accelerated Vesting:** Employees receive faster vesting of their shares or options under specific circumstances.

    - Events such as a company acquisition, merger, or the employee's retirement, termination without cause, disability, or death can accelerate the vesting schedule.

5. **Reverse Vesting:** Typically used in startup scenarios where founders or key employees receive shares upfront, but the company has the right to buy back unvested shares if the employee leaves before the vesting period is complete.

    - **Purpose:** Ensures that founders or key employees remain with the company for a minimum period to retain ownership of their shares.

TAXATION OF ESOP’s IN INDIA FOR UNLISTED COMPANIES

A. AT THE TIME OF EXERCISE:

- Tax are applied 2 times 1st is When an employee exercises their stock options, they convert their options into actual shares of the company. This triggers a tax liability known as perquisite tax under the head "Salary Income."

- **Prequisite tax:** tax on fringe benefits.

- **Fringe benefits:** Extra compensation companies give their employees.

- **Fair Market Value (FMV):** The perquisite is calculated as the difference between the Fair Market Value (FMV) of the shares on the date of exercise and the exercise price (the price at which the options were granted to the employee).

- **Tax Liability:** This difference is treated as part of the employee's salary and taxed according to the applicable income tax slab rate of the individual.

- Eg:

  I. Grant Price (Exercise Price): ₹100 per share
  II. FMV on Date of Exercise**:** ₹500 per share
  III. Perquisite Value: ₹500 - ₹100 = ₹400 per share
  IV. If the employee exercises 1,000 options, the perquisite value will be ₹400 * 1,000 = ₹4,00,000.
  V. This ₹4,00,000 will be added to the employee’s salary income and taxed according to their income tax slab rate.

B. AT THE TIME OF SALE:

- When the employee eventually sells the shares, they are subject to Capital Gains Tax. The type of capital gain (short-term or long-term) depends on the holding period of the shares.

- **Cost of Acquisition:** The cost of acquisition for calculating capital gains is the FMV of the shares on the date of exercise (which was used to calculate the perquisite tax).

- **Holding Period:**

  a) **Short-Term Capital Gains (STCG):** If the shares are sold within 24 months from the date of exercise, the gains are considered short-term.

b) **Long-Term Capital Gains (LTCG):** If the shares are sold after 24 months from the date of exercise, the gains are considered long-term.

- **Tax Rates:**

  a) **STCG:** Taxed at the normal income tax rates applicable to the individual.

  b) **LTCG:** Taxed at 20% with the benefit of indexation.

- Eg:

  a) **FMV on Date of Exercise (Cost of Acquisition):** ₹500 per share

  b) **Sale Price:** ₹800 per shares.

  c) **Capital Gain per Share:** ₹800 - ₹500 = ₹300

    - If the employee sells 1,000 shares:
    - If sold within 24 months (STCG): The gain of ₹300,000 (₹300 * 1,000 shares) will be taxed at the applicable income tax rate.
    - If sold after 24 months (LTCG): The gain of ₹300,000 will be taxed at 20% with indexation benefits.

COMMON PITFALLS WHILE IMPLEMENTING ESOP's

1. No clear expectations / mismatch of expectations of employees and management- Also it's expectation should be given at the start of the plan.
2. Excessive dilution or insufficient ESOP pool.
3. Implementing scheme without factoring the stage of the business.
4. Uncertain or complex terms and conditions – Creates confusion/ misunderstandings (like making performance evaluation metrics which is complicated).
5. No clarity on liquidity event – Regular liquidity event which boost the employee confidence.

TASK 1: HOW TO RETAIN TALENT USING ESOP’s

1. Fisrt and foremost thing is we need to identify talented employees who’s vision align with the companies vision.

2. Go getters should be given priority.

3. Alinging ESOP’s with the long term performance goals(revenue growth, profitability, market share, customer satisfaction or innovation milestones), Long term retention by structuring vesting scheduled in tiers.

4. Mainly we should be able to create an awareness about ESOP’s and how it is been regulated and laws governing it so that they feel it is more transparent rather an company gimmick.

5. They should be able to witness the result on how it is working.

6. It should be made flexible for employes’s based on their years of experience and their performance.

7. Combine ESOP’s with competitive salaries, bonuses, career development opportunities, and other benefits such as health insurance and retirement plans. Recognize and reward employees' achievements and contributions regularly, ensuring they feel valued beyond the ESOP’s.

8. Diversify ESOP’s options within a company although it might sound complicated but the more flexible options allow the employees to have various options.

9. Foster a Culture of Ownership and Participation through communication and educational programs.

10. Creating a detailed plan with clear milestones and deadlines is crucial for a smooth ESOP program rollout.

TASK 2: Continuation of Task 1

1. **How to make employees feel comfortable while issuing ESOP's?**

   - We can make ESOP's launch party just like ipo launch party with food music and decorations, parties are the place where individual or group meetings be held informaly this event can increase excitement and positive atmosphere around ESOP's.
   - We can present it through many ways like making presentations about it or organise an game(quizzes) around it or we can perform an act about it , or we can tell the success stories about it like how many people life changed within a night.
   - We can create an workshop about it which will provides financial literacy about it.
   - We can let the employees make an ppt , act or something creative about it and we can award the best about it.
   - We can tell them about the rules and regulations that surround the ESOP's. ESOP's are regulated by section 62(1)(b) of the Companies Act 2013 and SEBI(SBEB and Sweat Equity Regulations) guidelines, 2021.

2. By providing appreciation rewards time to time?

   - We can issue them more stock option if they complete their project before their schedule which contributes to the growth of the company.
   - More flexible work life balance.
   - Recognise their feedback on work on it solve the issues pertaining.
   - Acknowledge their contributions company wide so that they can build more connections
   - Appreciate their contributions by celebrating time to time so that they feel that their company takes care of them from time to time.

3. Providing proper traning about the work.

   - We should tell them how the company value increase if they can handle multiple projects than before or how if they complete their project on or before time .
   - How the ESOP's gonna workout for their personal financial planning, retirement planning and tax strategies.

4. Company also should aware of weak and strong points of its employees, while issuing ESOP's

    - Manager observation also through informal meetings.
    - Using KPI's also reports about their performance.
    - Self assesments.
    - Conducting different activities and reviewing their performances.
    - Evaluate their skills in critical areas.
    - Feedback from colleagues about their behaviour and personality.

5. Giving some responsibilities to employees other than their major work to enhance their experience.

    - Talent acquisition programs.
    - Sustainabilty and environment programs.
    - CSR initiatives.
    - Project manager
    - Mentoship and training.

TASK 3: Don'ts of ESOP's

1. **Don't over dilute equity:**
    - Giving away too much equity can dilute the ownership of founders and early investors. This can also reduce the motivation of employees if the value of their shares decreases significantly.

    - It should be around 10-15percent and increase esop pool parallel to company growth.

    - **Seed Stage**: At this stage, companies might allocate 15% to 20% for ESOP's.

    - **Series A/B Funding**: After initial funding rounds, companies often allocate 10% to 15%.

    - **Late-Stage**: Companies approaching an IPO or acquisition might reduce the ESOP pool to around 5% to 10%.

    - **Early-Stage Startups**: Typically, early-stage startups allocate a higher percentage of equity for ESOP's to attract and retain talent when cash compensation might be limited. This can range from 10% to 20% of the total equity.

- **Growth-Stage Companies**: Companies that are more established but still growing might allocate around 5% to 15% of equity for ESOP's.

- **Mature Companies**: Established companies with stable revenues might allocate a smaller percentage, usually around 2% to 5%.

2. **Don't Treat All Employees Equally:**

   - ESOP's should reward key employees and top performers adequately. While it's important to be fair, equal distribution regardless of contribution can demotivate high performers.

3. **Don't Overcomplicate the Plan:**

   - Esop does require management but it shouldn't be complicated

   - Thongs that make it complicated or tax, non transparency,etc

   - Employees may face taxation at multiple points, such as at grant, vesting, exercise, and sale of shares. Understanding and communicating these tax implications is crucial.

   - The company may also have tax obligations related to the issuance and management of stock options.
   - While it's important to address various scenarios and contingencies, overly complex plans can be hard to manage and understand. Keep it as simple as possible while covering the necessary bases.

4. **Don't Set Unrealistic Vesting Schedules:**

   - Vesting schedules that are too long can demotivate employees, while schedules that are too short can lead to high turnover. A common practice is a four-year vesting schedule with a one-year cliff.

5. **ESOP's should not be mismanaged:**

   - Regularly reviewing the ESOP pool size and allocation strategy ensures that it continues to meet business objectives and employee expectations. By following a structured approach, companies can maintain a competitive edge in talent acquisition and retention while aligning employee incentives with long-term business success.

6. **Failing to pay ESOP participants their distributions on time:**

   - ESOP participants are entitled to receive distributions from their ESOP accounts on a regular basis. Failing to pay these distributions on time can result in penalties and other legal problems. On distributions are easily scheduled well in advance of deadlines.

7. **Lack of clarity/proper communication**:

   - we should show them the growth rate and what are its implications on ESOP's.

THANK YOU