What is ESOP?

ESOP stands for Employee Stock Option Plan. It is a system under which generally the employees are given a right to acquire shares of the Company for which they are working. Under such scheme the employees are granted some rights called as stock options to get shares of the Company at free or at concessional rate, at a predetermined price or the price to be determined on the prefixed method, as compared to the potential market rate. It is an agreement that gives the holder (the "Optionee") the right (with no obligation) to purchase within a particular time, specified number of Shares at a specified price ("Exercise Price").

Why ESOPs are given?

There are various reasons for which the employees are given such stock options. The phenomena of stock options is more prevalent in start-up companies which cannot afford to pay huge salaries to its employees but is willing to share the future prosperity of the Company. Moreover, in some of the cases the employee is given such stock options which he can exercise in future date/s, in order to ensure long term commitment of the employee. So apart from rewarding the employees with monetary gains, ESOP also helps create a sense of belonging and ownership amongst the employees.

Why is an Option valuable?

An Option as valuable as it gives the Optionee the right (with no obligation) to purchase the Shares at a pre-set price. As a result, if the Shares increase in value, the Option grantee is able to purchase the Shares at the lower Option Price. However, if the Shares decline in value after the Option is granted, so long as the Option grantee has not Exercised the Option, he or she has not suffered any loss.

If I have Stock Options does that mean I own shares?

The Options are not actual Shares, but a right. They become Shares when the right is exercised.

Understanding vesting date and grant price?

Under the ESOP schemes the stock option is free when it is given to an employee. The terms and conditions on which employee can exercise his rights are spelt in the ESOP scheme. The option given to the employee can be exercised after a certain lock in period.

The right to exercise the option may get vested in the employee in the next future date/s. The dates on which the employee becomes entitled to exercise the right to acquire the shares is called as "vesting date". The rights may vest fully or partially over the vesting period. For example, an employee is given 1000 options on 31st March 2019 which can be exercised in phases like 20% on completion of one year, 10% on completion of each subsequent Quarter from the date of such grant. So in the instant case the vesting dates for 200 options is 1st April, 2020, for next 100 shares it is 1st July 2020, for next hundred it is 1st October 2020 and so on, the last instalment being 1st April 2022 for last 100 shares. The plan may stipulate same or different grant price or exercise price for such vesting. The grant price or the price at which the employee can buy the share from the company are generally fixed and is generally substantially lower than the prevailing market price of the shares in case the shares are listed.

Since the employee is given just an option without any obligation attached to it, it is not mandatory for the employee to exercise the option. The employee may decide to exercise the option or may decide to let the option lapse in case the prevailing price of the shares is lower than the exercise price. The employee is given a time period during which the he has to exercise the option failing which the vested rights may lapse. The date on which the employee exercises his option to buy the shares is known as '**exercise date'**.

There are no cash outflow or taxation implications when the options are granted as well as when the options are vested in the employee.

When to exercise options?

It is not necessary for an employee to exercise the option once it vests with him. The employee can exercise the right within stipulated time period. When the employee should exercise the options is very important question from financial and taxation angle as well. Once the employee exercises the option, he must pay for the shares at the price predetermined and thus causing cash outflow. In case the shares are not listed on stock exchange, the same cannot be liquidated and thus the money gets locked till the shares get listed or the promoters offer you an exit option. Moreover, there is taxation implication if you delay your exercise date because the holding period for capital gains purpose will start from the exercise date. So, the decision must be taken after having considered cash flow and taxation implications of such decision.

The tax implications when exercising the option:

The taxation of ESOP has a typical structure. It is taxed in two stages. First stage is when the employee exercises the option to buy the shares at the exercise price. The second stage is when the shares are ultimately sold.

Let us first discuss the first stage. As and when the options under the ESOPs are exercised, the difference between the exercise price and the value of the security is treated as "*perquisite in the hands of the employee*". The employer is required to deduct tax at source on the employee exercising the option, treating the same as perquisite. The value of the shares allotted to the employee shall be the average of market price (average of highest and lowest price) on the date the option is exercised in case the shares are listed on any stock exchange in India. In case the shares are not listed the fair market value of the same shall be as per the valuation certificate obtained from merchant banker. The certificate of valuation of shares should not be older than 180 days from the date of exercise of the option. Even if the shares are listed outside India, the Company will have to obtain the certificate from Merchant Banker as such shares are treated as unlisted shares for ESOP purposes.

What is Vesting?
Vesting refers to the process of an Option grantee becoming exercisable and is typically tied to continued employment with the Company. Thus, as the Option Vest, you may Exercise the Vested portions of your Options.

How long does it take stock Options to Vest?
Vesting typically will begin after the Expiry of 12 months from the date of the issue of the Options. The vesting schedule in your Grant Letter details this information.

Should I buy the Shares when they Vest?
Not necessarily, when the Options Vest, you may Exercise the Option at any time before the Option expires.

What is Exercise?
Exercise is when the Option grantee purchases the Shares from the Company at the Option Price, relying on the right given to him / her under the Option.

Are there a minimum number of Shares I need to Exercise?
No. However an Option grantee cannot be exercised to obtain a fraction of a Share.

When does an Option expire?
Typically, the maximum period within which the Options are vested shall be three years from the date of Vesting of Options, provided your employment status does not change (e.g. – termination, disability, superannuation). The Option may be exercised only within the term set out in the Option Agreement.

The Options granted shall also expire, if the Eligible Employee or his legal heir / nominee, do not exercise it with in the Exercise Period.

How do I exercise my Options?

The Option is exercisable by delivery of the duly completed Exercise Notice to the Company.

The exercise notice shall be accompanied by the full Exercise price as to the Shares with respect to which the Options are exercised. The Options shall be deemed to be Exercised on the effective date of Exercise.

When should I exercise an option?

The decision to exercise your options will probably depend on a number of factors – such as the current market price of the stock, your estimate of future stock prices, your tax situation, and your personal investment goals. You should also consult with your personal financial or tax advisor when considering tax planning.

What is the effective date of Exercise?

The effective date of Exercise is the date the Company receives the Exercise Notice duly completed, any other form or undertaking as required by the Company and payment of Exercise price from the Option grantee.

What are my rights as a Shareholder on Exercise?

Until the Shares are issued, no right to vote or receive dividends or any other attendant Shareholder rights shall exist with respect to the Optioned equity Shares, despite the Exercise of the Option.

The tax implication when the shares acquired under ESOP are disposed off

Now let us understand the second leg of the taxation of the ESOP shares i.e. when the employee actually sells the shares. The incidence of sale will attract capital gains tax. The gains can be either long term or short term depending on the period for which the employee has held the shares.

Note:
With effect from Assessment Year 2017-18, period of holding to be considered as 24 months instead of 36 months in case of unlisted shares of a company,

For the purpose of computation of the capital gains the fair market value as on the date of exercise, taken into account for the purpose of perquisites of the options, is treated as the cost of acquisition and not the price actually paid by the employee.

The tax implications would be different in case the ESOPs are allotted to a person who is not an employee either by the holding or subsidiary company or the any non-executive director or any other eligible person. The question of it being taxed as perquisite does not arise when the option is exercised by such persons however the capital gains tax will have to be paid as and when such shares are sold.

When Should you sell the shares?

The decision to sell the shares acquired under ESOP is like any other investment decision. You need to consider the capital gains implication as well as the need for liquidity for arriving at the decision. Moreover, whether and when to sell decision will also depend on the prospects of the Company. It may also happen that the shares which you have acquired under ESOP are not listed, so in such situation you cannot sell the shares until the shares are listed or the promoters offer you an exit, which may not be at very attractive terms. In such a situation, it will make sense for you to wait a little till the shares are listed on stock exchange.