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Employees Stock Option (ESOP)

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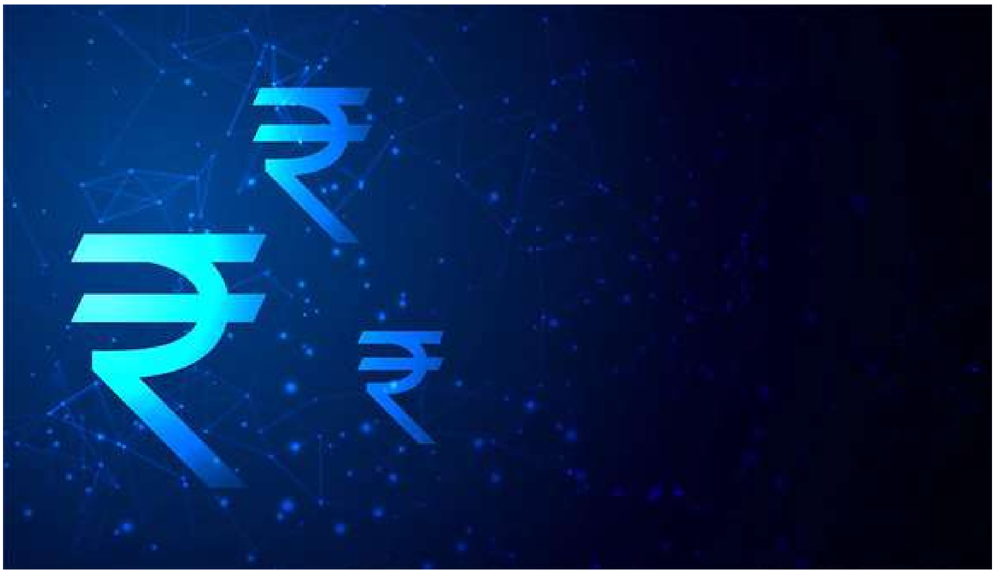

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Employees Stock Option (ESOP)

Commerce & Accountancy Notes for SEBI Grade A Exam

What is ESOP?

The term employee stock option (ESOP) refers **to a type of equity compensation granted by companies to their employees and executives.**

Rather than granting shares of stock directly, **the company gives derivative options on the stock instead.**

These options come in the form of regular call options and give the employee the right **to buy the company's stock at a specified price for a finite period of time.**

Terms of ESOPs will be fully **spelt out for an employee in an employee stock options agreement.**

In general, the greatest benefits of a stock **option are realized if a company's stock rises above the exercise price.**

Typically, ESOPs are issued by the company and cannot be sold, **unlike standard listed or exchange-traded options.**

When a stock's price rises above the call option exercise price, call options **are exercised and the holder obtains the company's stock at a discount.**

The holder may choose to immediately sell the stock **in the open market for a profit or hold onto the stock over time.**

Key Takeaways

- Employee stock options are offered by companies **to their employees as equity compensation plans.**
- These grants come in the form of regular call options and give an employee the right **to buy the company's stock at a specified price for a finite period of time.**
- ESOPs can have vesting schedules **that limit the ability to exercise.**
- ESOPs are taxed at exercise and **stockholders will be taxed if they sell their shares in the open market.**

- They can have significant time value **even if they have zero or little intrinsic value.**
- Stock options are a benefit often associated with start-up companies, which may issue them in order **to reward early employees when and if the company goes public.**
- They are awarded by some fast-growing companies as an incentive for employees **to work towards growing the value of the company's shares.**
- Stock options can also serve **as an incentive for employees to stay with the company.**
- The options are cancelled if the employee **leaves the company before they vest.**
- **ESOPs do not include any dividend or voting rights.**

Understanding ESOP

Corporate benefits for **some or all employees may include equity compensation plans.**

These plans are known for providing financial compensation in the form of stock equity.

ESOPs are just one type of equity compensation a company may offer**.**

Other types of equity compensation may include:

- Restricted Stock Grants: these give employees the right to acquire or receive shares once certain criteria are attained, like working for a defined number of years or meeting performance targets.
- Stock Appreciation Rights (SARs): SARs provide the right to the increase in the value of a designated number of shares; such increase in value is payable in cash or company stock.
- Phantom Stock: this pays a future cash bonus equal to the value of a defined number of shares; no legal transfer of share ownership usually takes place, although the phantom stock may be convertible to actual shares if defined trigger events occur.
- Employee Stock Purchase Plans: these plans give employees the right to purchase company shares, usually at a discount.

For employees, the key benefits of any type of equity compensation plan are:

- An opportunity to share directly in the company’s success through stock holdings.

- Pride of ownership; employees may feel motivated to be fully productive because they own a stake in the company.

- Provides a tangible representation of how much their contribution is worth to the employer.

- Depending on the plan, it may offer the potential for tax savings upon sale or disposal of the shares.

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The benefits of an equity compensation plan to employers are:

- It is a key tool to recruit the best and the brightest in an increasingly integrated global economy where there is worldwide competition for top talent.
- Boosts employee job satisfaction and financial wellbeing by providing lucrative financial incentives.
- Incentivizes employees to help the company grow and succeed because they can share in its success.
- May be used as a potential exit strategy for owners, in some instances.

In terms of stock options, there are two main types:

1. **Incentive stock options (ISOPs),** also known as statutory or qualified options, are generally only offered to key employees and top management. They receive preferential tax treatment in many cases, as the IRS treats gains on such options as long-term capital gains.
2. **Non-qualified stock options (NSOPs)** can be granted to employees at all levels of a company, as well as to board members and consultants. Also known as non-statutory stock options, these profits are considered ordinary income and taxed as such.

Important Concepts

There are two key parties in the ESOP, **the grantee (employee) and the grantor (employer).**

The grantee, also known as the options - can be an executive or an employee, while the **grantor** is the company that employs the grantee.

The grantee is given equity compensation in the form of ESOPs, usually with certain restrictions, one of the most important of which is the vesting period.

The vesting period is the length of time that an employee must wait in order to be able to exercise their ESOPs.

Because it gives the employee an incentive to perform well and stay with the company.

Vesting follows a pre-determined schedule that is set up by the company at the time of the option grant.

ESOPs and Taxation

The following points need to be borne in mind with regard to ESOP taxation:

- The option grant itself is not a taxable event.
- The grantee or optionee is not faced with an immediate tax liability when the options are granted by the company.
- Note that usually (but not always), the exercise price of the ESOPs is set at the market price of the company's stock on the day of the option grant.
- Taxation begins at the time of exercise.
- The spread (between the exercise price and the market price) is also known as the bargain element in tax parlance and is taxed as ordinary income tax rates because the IRS considers it as part of the employee's compensation.
- The sale of the acquired stock triggers another taxable event.
- If the employee sells the acquired shares for less than or up to one year after exercise, the transaction would be treated as a short-term capital gain and taxed as ordinary income tax rates.
- If the acquired shares are sold more than one year after exercise, it would qualify for the lower capital gains tax rate.

The non-tradable nature and other limitations of ESOPs may make their early exercise necessary in the following situations:

- **Need for Cashflow:** Oftentimes, the need for immediate cashflow may offset the opportunity cost of time value lost and justify the tax impact.
- **Portfolio Diversification:** As mentioned earlier, an overly concentrated position in the company's stock would necessitate early exercise and liquidation in order to achieve portfolio diversification.
- **Stock or Market Outlook:** Rather than see all gains dissipate and turn into losses on account of a deteriorating outlook for the stock or equity market in general, it may be preferable to lock in gains through early exercise

Delivery for a Hedging Strategy: Writing calls to gain premium income may require the delivery of stock.

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