Preparing an Employee Stock Option Plan (ESOP) in Singapore

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Whether you are a capital-scarce start-up looking to put together a dream team or an established company seeking long-term hires, attracting talent — and keeping them — remains a difficult challenge.

With job-hopping increasingly the norm and talent flight ever prevalent, getting people to commit to the job might require more than just a good paycheck.

Employee Stock Option Plans (ESOP) are a good fit to this puzzle. But just like any puzzle piece, figuring out how to make sense of ESOPs can be a confusing affair in itself.

This article will introduce you to ESOPs and explain key concepts and, implications, and terms you need to understand before introducing an ESOP.

What is an Employee Stock Option Plan (ESOP)?

An ESOP gives employees the **right to purchase shares** in the company at a specific pre-determined price, within a certain set time-frame.

What makes ESOPs particularly advantageous for attracting and retaining talent is the **sense of ownership** it confers on employees, and the **strong incentive for their longer-term commitment** to the company.

Giving employees a slice of the pie means that employees stand to benefit directly from an increase in the value of the company, which may provide a strong motivating factor for them to work hard and commit to the company for longer.

By designating a certain period of time before employees are able to exercise their right to purchase the shares allocated to them, ESOPs may also further incentivise employees to commit long-term in order to take advantage of their share options.

For smaller companies, ESOPs provide another means of compensation if these companies are unable to pay in cash the salaries of their employees. Small companies can compensate their employees with stock options that equal the difference between their employees' full market salary and cash salary.

Conversely, ESOPs may limit benefits for newer employees.

Since the number of shares given to an employee depends on how long the employee has been with the company, more shares may be allocated to senior employees. This in turn may grant them higher voting power than newer hires, constraining opportunities for newer employees to participate in decision-making.

As a result, new employees may not gain an equally strong sense of ownership in the company but feel alienated from the employees enjoying their senior rank benefits, and the effectiveness of your ESOP as a tool for retaining talent may be adversely affected.

The following may be kept in mind before preparing an ESOP:

ESOP Pros	ESOP Cons
Motivating factor for employees to commit longer to the company.	New employees have lesser opportunities in decision-making and may lose their sense of company ownership, resulting in possible challenges in the company's ability to retain talent.

Small companies that are unable to pay salary may compensate employees through ESOPs.	

ESOP vs Employee Share Ownership Plans (ESOW)

An ESOP is essentially a type of Employee Share Ownership (ESOW).

An ESOW plan is any plan that allows an employee of a company to own or purchase shares in the company or in its parent company. ESOWs also usually exclude phantom shares and share appreciation rights.

Phantom shares are essentially promises to pay a bonus in the form of either cash or equity that is equal in the value of company shares, or the increase in that value, over a stipulated time period.

On the other hand, share appreciation rights are similar to phantom shares, but also give employees the right to a cash equivalent of the increase in value of a predetermined number of shares, over a designated period of time.

As for ESOP plans, they are a specific type of ESOW that gives employees rights to purchase shares in the company **at a pre-determined price within a specific time-frame**.

How Can an ESOP be Structured?

An ESOP can be structured by an ESOP Agreement that creates an Employee Stock Option Pool (ESOP Pool) that sets aside a percentage of equity shareholding for employees. Employees can participate in the shares of the company via this pool of shares.

An ESOP Agreement will include the details of members of an **ESOP committee**. Such a committee typically includes directors and other officers in the company, and is responsible for managing the ESOP Pool and recommend relevant actions to the company's Board of Directors.

An ESOP may also include a **Cliff** and/or **Vest** period. These periods have different implications on whether an employee receives stock options or not.

If an employee leaves the company during the **Cliff** period of an ESOP, he/she will not receive any stock options.

On the other hand, the **Vest** period refers to the period of time before shares in an ESOP are unconditionally owned by the employee. If an employee leaves during the Vest period, which usually succeeds the Cliff period, he/she will be given pro-rated stock options based on the length of time they have stayed with the company.

Additionally, an ESOP may also include a **selling restriction**, or a time period within which an employee may not sell his or her shares.

For example, instead of allowing an employee to exercise all 10,000 of his/her shares after a fixed time period, your ESOP may instead restrict him/her to exercising only 2,000 shares at 6-month intervals.

How an ESOP may be structured depends on your company's financial health, needs and objectives. Below is a list of guiding questions for your reference:

1. How much should your employee be paid, according to market standards?
2. How much of your employee's salary can you pay in cash?
3. How long do you need to compensate for the gap between your employee's cash salary and his/her full market salary?

4. How much should you value your stock options at?
5. How many stock options should you grant?

Here is an example to illustrate the features of a **cliff** period**, vest** period and **selling restriction**:

Max is hired by company A and is given 30,000 shares as part of his employment package. These options are subject to a 2-year cliff so, Max must remain employed by company A for 2 years before he is able to exercise his stock options.

The options are also subject to a 3-year vest, and Max can purchase the shares granted to him at a rate of 20 cents per share.

During the vesting period, a designated portion of Max's shares become exercisable after each year in the vesting period. Because his share options are subject to a 3-year vest, Max is restricted to only exercising 10,000 shares for each year in the 3-year vesting period.

At the end of the vesting period, all of Max's shares will become exercisable.

In addition, when Max's shares become exercisable, or vested, he has the option to then purchase his shares at 20 cents per share as per the terms of the ESOP. This is even if the share price has already increased significantly relative to the price agreed upon in the employment package.

Hence, Max buys his shares at 20 cents per share even though their present value is now 60 cents per share.

What are Some Important Terms in an ESOP?

While ESOPs vary between individual companies, every good ESOP should include the following:

1. Who is eligible for the ESOP i.e. a set of **eligibility criteria** to qualify or disqualify certain employees from taking part in the ESOP.
2. A **time period and/or a set of conditions** stipulating when the ESOP is granted. Granting means giving your employees the option to purchase your company's shares.
3. Clearly defined presence or absence of a **vesting period.**
4. Who is in the **ESOP committee**, and what the functions of the ESOP committee are.
5. Number of **ESOP shares** issued.

Are There Any Tax Implications on Employers?

A company is granted tax deductions on any costs incurred to acquire its own shares, so as to transfer these shares to employees under the ESOP. This is provided that the ESOP granted to the employee falls under the **Qualified Employee Equity-Based Remuneration Scheme (QEEBR)** (discussed below).

What About the Tax Implications on Employees?

An employee who is given share options via an ESOP will be taxed on any gains arising from the exercise of the share option.

How the gains from the exercise of the share option will be taxed depends on when the share option was granted. For example, gains from an ESOP with no vest period are taxable the year when the shares are granted.

For gains from ESOPs with a vesting period, these are taxable in the year when the ESOP is exercised if there is no selling restriction. If such a selling restriction is present, then gains from the ESOP will be taxed only in the year when the selling restriction is lifted.

Under the Inland Revenue Authority of Singapore (IRAS)' **QEEBR**, tax on gains from share options derived from an ESOP can be deferred up to a maximum of 5 years, subject to an interest charge.

For an ESOP to qualify for tax deferment under the QEEBR, the following conditions must be met:

1. If the exercise price of the option is equal to or more than the open market price at the time of being granted, the ESOP cannot be exercisable within a year from the grant of the option. If the exercise price of the option is less than the open market price, then this vesting period requirement goes up to 2 years. If a company is not a listed company, the company's net asset value (i.e. the difference between the company's assets and liabilities) will be used in place of the open market price.
2. If your ESOP has a staggered vesting period, only the proportion of shares that have not vested may qualify for tax deferment. For example, if only 40% of an employee's share options have vested so far, then the remaining 60% of the share options will qualify for tax deferment.
3. The employee must still be employed in Singapore at the time of the grant of the ESOP, as opposed to the time of exercise of the ESOP. That means that an ESOP qualifies if the employee receives the share options while working in Singapore.
4. The employee who is granted an ESOP is not an undischarged bankrupt, does not possess a poor tax-paying record, has tax on stock options gains more than $200, has not been granted area representative status, and is allowed to settle tax by instalments under current tax rules.

An employee is not granted representative status if he/she falls within any one of the following:

- Employed by an employer resident in Singapore
- Not based in Singapore
- Not required to travel outside of Singapore
- The employee's remuneration is charged directly, or indirectly, to the accounts of a permanent establishment in Singapore from which business is conducted, such as an office or factory.

As an employer, you will not need to apply to IRAS for approval to have such plans considered as qualified ESOP or ESOW plans.

However, you will be required to keep proper records to prove that your ESOP meets the vesting period requirement, and certify on your employee's application form for tax deferral that your company's ESOP qualifies for tax deferment.

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ESOPs are powerful incentives for keeping talented employees, and every company, regardless of size or industry, should consider introducing one.

However, how an ESOP may be structured — from the duration and nature of the vesting period to how large the employee options pool should be — can be difficult to figure out, and you may wish to consult a lawyer on this beforehand.