ESOPs 101

Turning Job Offers into **Wealth Opportunities**

What are ESOPs and how do they work?

ESOPs or Employee Stock Ownership Plans are a unique employee benefit program offered by many companies, including startups, as a way to reward and incentivise their employees. ESOPs grant you the opportunity to become partial owners of the company by allowing you to purchase company shares at a predetermined price. Here's what the journey looks like:

Equity allocation

When a company starts an ESOP, it sets aside a certain amount of equity for the ESOP pool, typically ranging from 5% to 20% of the company's total equity. This ESOP pool is then allocated to eligible employees in the form of stock options.

Vesting Period

To ensure your commitment and retention, ESOPs often come with a vesting period. During this time, you gradually earn the right to exercise your options.
For example, if you have a four-year vesting schedule with 25% vesting each year, you would gain access to 25% of your granted options after the first year, and so on.

Exercising Options

Once your options are vested, you can exercise them by purchasing the company shares at the predetermined exercise price. This means you become an actual shareholder of the company and can benefit from any increase in the company's stock value.

Liquidity Events

The real wealth creation potential of ESOPs often becomes evident during liquidity events. These can include the company going public (IPO) or being acquired by another company. During such events, you may have the opportunity to sell your vested shares at the current market price, potentially realising significant financial gains.

Tax Considerations

It's important to note that ESOPs have tax implications at various stages, such as when you exercise your options or sell your shares. Understanding the tax rules is essential to optimise the financial benefits of ESOPs.

How can the ESOPs benefit me?

The traditional paycheck alone no longer satisfies the aspirations of many employees. This is where Employee Stock Ownership Plans (ESOPs) come into play, offering you a host of appealing benefits that go beyond the paycheck.

Ownership and Stake in the Company

ESOPs provide you with a sense of ownership in the startup. You become a shareholder and have a stake in the company's success.

Alignment of Interests

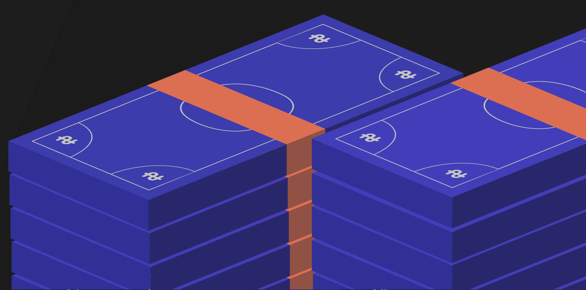
As an ESOP holder, you have a vested interest in the startup's growth and profitability.

Motivation and Commitment

Your efforts can directly impact the value of your ESOPs, hence, it can motivate and encourage you to work diligently to contribute to the company's long-term success

Retirement Planning

ESOPs can serve as a valuable component of your retirement planning. As you accumulate ESOP, you build an asset that may provide financial security during your retirement years.



Financial Security

If you have ESOP, you have an asset that may appreciate in value over time, providing a financial cushion.

Tax Benefits

Depending on the specific ESOP plan and tax regulations, you can defer taxes on ESOP gains for a certain period if the startup is India registered and meets the criteria. However, it's important to note that taxation typically occurs at the time of exercise, and any deferral is subject to specific eligibility conditions.

Liquidity Events

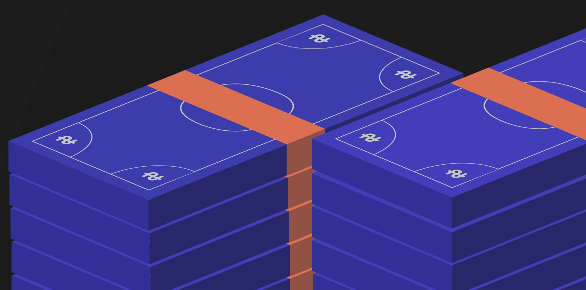
Startup journeys often involve liquidity events such as mergers, acquisitions, or buybacks. These events can provide you with opportunities to sell your ESOP and realise the gains you've accumulated.

Diversification

ESOPs can diversify your investment portfolio. If you have other investments, ESOPs represent an additional asset class that can spread your risk.

Wealth Creation

If the startup succeeds and its valuation increases, the value of your ESOP holdings can also grow significantly. ESOPs can also help you create wealth when the organisation decides to buy back ESOPs. Let's understand what buying back ESOPs means and how it helps in wealth creation.



Can I really supercharge my wealth through ESOP buybacks?

Yes, you can!

ESOP buybacks refer to the process of a company buying back vested stock options from its employees for cash by way of cancellation or surrender of vested options. Companies may opt for ESOP buybacks to provide employees an exit, reward employees for their contributions, or list gains if they believe their valuation can go higher.

ESOP buybacks have made ESOPs an attractive component of compensation packages. According to the report by Cutshort, Indian startup employees have made more than $159 Million in ESOP buybacks.
That's nearly ₹1200 Cr. averaging at around ₹1.2 Cr. per employee.

2022

$200 MILLION

Swiggy, Razorpay, Ninjacart, Slice and 21 other startups

2021

$440 MILLION

Flipkart, Spinny, PhonePe, Udaan, ShareChat and 8 others collectively

2020

$50 MILLION

Zerodha, Swiggy, Unacademy, FirstCry, Urban Company, and Meesho and 5 other Indian startups

In a nutshell, these developments highlighted ESOPs as a valuable tool for you to generate wealth beyond your paycheck.

How can IPO and M&A impact my ESOPs?

IPO (Initial Public Offering) and M&A (Mergers and Acquisitions) are significant events that can have a substantial impact on your Employee Stock Ownership Plans (ESOPs). Here's how:

IPO (Initial Public Offering)

Liquidity Event: When the startup goes public through an IPO, your ESOPs can become tradable on the stock exchange, only if the ESOPs are vested or exercised. This provides you with an opportunity to sell your shares to the public or other investors, converting your ownership into cash.

Market Valuation: The market's perception of your company's value can influence the market price of your ESOP. If the IPO is successful and the stock price increases, the value of your ESOP holdings may rise significantly.

Unlocking Value: IPOs can unlock the value of your ESOPs, allowing you to realise the gains you've accumulated over the years. This can be especially beneficial if the IPO results in a higher share price than your exercise price.

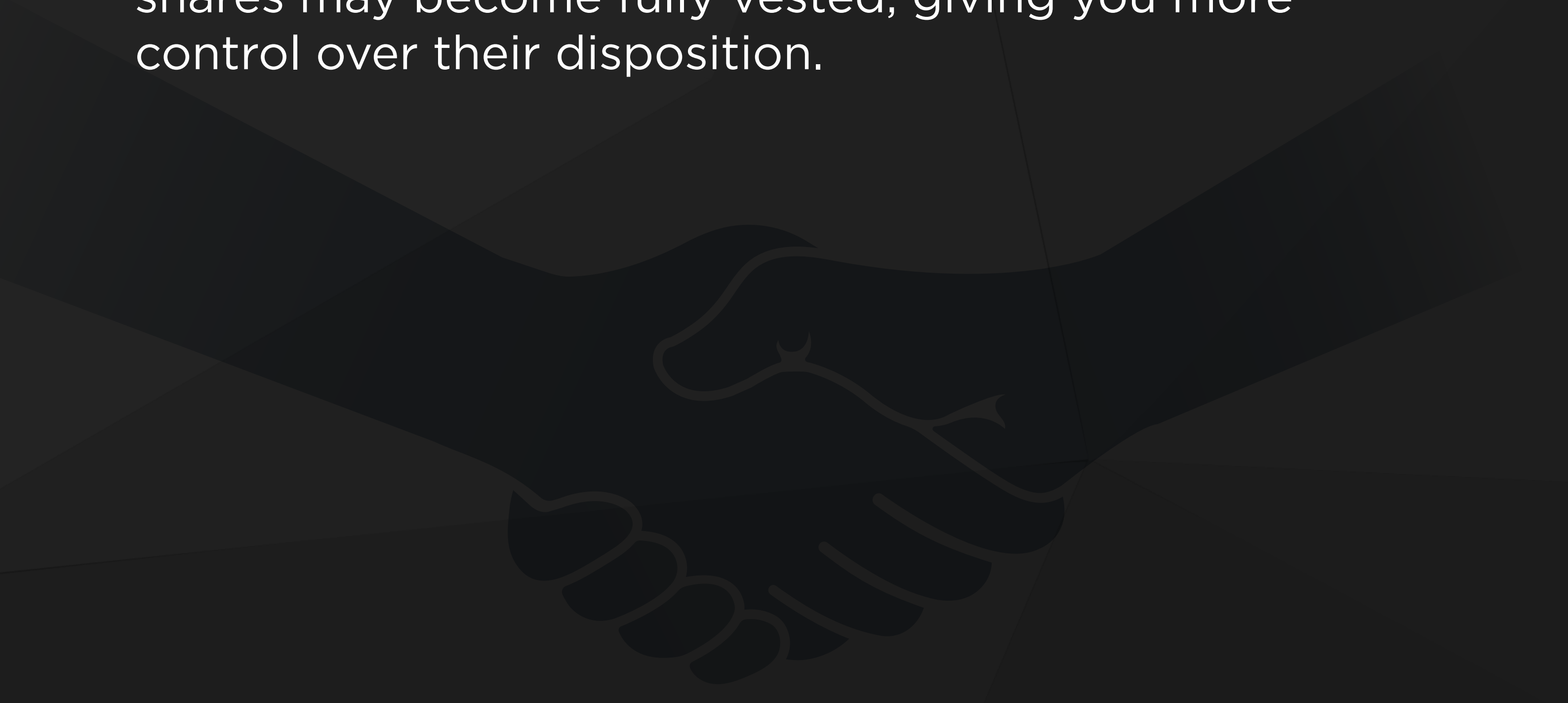
Mergers & Acquisitions

Change in Ownership: In the case of an acquisition, your startup may be bought by another company. This can lead to a change in ownership structure, affecting the value and status of your ESOPs.

Cash Offer: If the acquiring company offers a cash buyout, you may have the option to sell your ESOP and receive a cash payment based on the buyout price per share.

Stock-for-Stock: In some M&A deals, you may receive shares of the acquiring company's stock in exchange for their ESOP. This can make you a shareholder in the new combined entity.

Vesting and Acceleration: The terms of your ESOP plan and any acceleration clauses may come into play during an M&A. Depending on the circumstances, your vested shares may become fully vested, giving you more control over their disposition.



How can I determine the value of my ESOPs?

Determining the value of your ESOPs at Indian startups can indeed be challenging due to the limited availability of specific company data. However, several key factors should be considered when calculating the current or potential future value of your Employee Stock Ownership Plans:

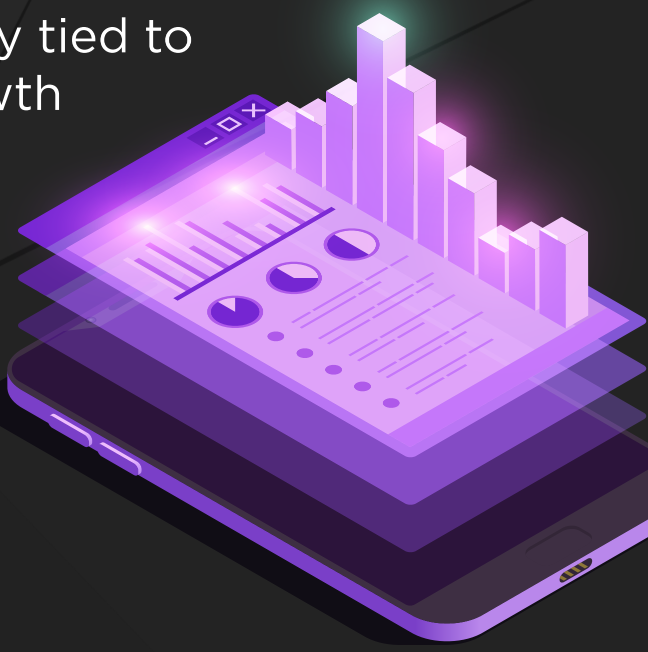
Fair Market Value (FMV)

The FMV represents the estimated current valuation of the company. For startups, this valuation hinges on factors such as the company's growth potential, market position, and financial performance. Typically, the FMV is determined by the company's management or an independent evaluator.

Exercise Price and Current Market Value

Calculating the value of your vested ESOPs involves subtracting the exercise price (the price at which you can purchase the shares) from the current market value of those shares. This market value is usually based on the most recent FMV determined by either the company's management or a professional valuator.

Company Performance and Funding



The value of your ESOPs is closely tied to the overall performance and growth of the startup, as well as its ability to secure additional funding. In cases where the company experiences success and attracts more funding, the value of your ESOPs may see a significant increase.

Vesting Period

Take into account the vesting period associated with your ESOPs, which is the stipulated time frame during which you must remain with the company to be eligible to exercise your options. The full value of your ESOPs may not be realised until the vesting period concludes.

Tax Implications

It's essential to be aware that tax implications may come into play when you decide to exercise your ESOPs or sell the shares. To navigate this complex terrain.

Market Research

Staying informed about industry trends and staying updated on news relevant to your startup and its sector can be instrumental. Changes in the market landscape, shifts in competitive positioning, or alterations in market conditions can all impact the potential future value of your ESOPs.

Exit Strategy and Liquidity Events

Consider the startup's prospective exit strategy, whether it involves acquisition or going public. The timing and terms of such events can wield a substantial influence on the value of your ESOPs.

What is a vesting period and how does it impact my ESOPs?

It is the specified period during which you must remain employed with the company or meet certain conditions to become eligible to exercise your ESOPs. Here's how the vesting period works and its effects on your ESOPs:

Vesting Schedule: ESOPs typically follow a vesting schedule that outlines when a portion of your stock options becomes available for exercise. Typically, the vesting schedule for the Indian startup ecosystem is 4 years. For example, a 4-year vesting schedule might grant you 25% of your ESOPs' total value each year, starting from the date of grant.

Cliff Vesting: Some ESOPs include a **"cliff"** period at the beginning of the vesting schedule. During this time, no portion of your ESOPs vests. After the cliff period ends, a significant percentage (e.g., 25% or 100%) vests, and then the remaining vesting occurs on a more gradual basis.

Impact on Ownership: The vesting period affects your ownership stake in the company. Initially, you may not have full ownership rights to your ESOPs. As time progresses and you meet the conditions outlined in the vesting schedule, you gain a greater share of ownership in the form of vested stock options.

Retention Tool: One primary purpose of the vesting period is to incentivise you to remain with the company for a specified duration. By tying the ability to exercise ESOPs to continued employment, companies encourage talent retention, aligning your interests with the long-term success of the business.

Risk Mitigation: The vesting period also serves as a risk mitigation measure for the company. It ensures that you have a vested interest in the company's performance and are more likely to stay committed to your roles.

Potential Forfeiture: If you leave the company before your ESOPs fully vest, you may forfeit the unvested portion. This means you would lose the right to exercise those options. The cliff period and gradual vesting are designed to strike a balance between rewarding tenure and ensuring commitment.

What happens if I leave my organisation in the middle of the vesting period?

If you leave your organisation in the middle of the vesting period of your Employee Stock Ownership Plans (ESOPs), the treatment of your ESOPs depends on whether they have vested or remain unvested:

Vested Portion

If you have already vested a portion of your ESOPs, you will retain rights over that vested portion even after leaving the company. These vested shares are yours to keep, and you can exercise them within the specified exercise window
(typically 25% of the ESOPs vest every year)

Unvested Portion

If you leave the company before the ESOPs are fully vested, the unvested portion will typically be cancelled. This means you forfeit the rights to the shares that have not yet vested. These unvested ESOPs are usually returned to the company's ESOP pool.

Exercise Window

For the vested portion of your ESOPs, you may have a limited time window, typically around **90 days,** to exercise them before they expire. If you do not exercise your vested options within this window, you may lose the opportunity to do so.

It's crucial to be aware that the treatment of ESOPs upon departure can vary significantly based on the terms and conditions of your specific equity plan and employment agreement. These terms can differ based on factors such as your role within the company, whether the company is public or private, and the specific vesting schedule outlined in your ESOP agreement.

What are the taxation implications on ESOPs?

As each financial year unfolds, startups and their employees keenly await the annual budget announcement with the hope of favourable amendments to ESOP taxation. The expectations run high, driven by the desire for policies that make ESOPs more accessible and tax-efficient. However, the budget for 2023, brought disappointment as it did not address the concerns surrounding ESOP taxation.

To shed light on the intricacies of ESOP taxation, let's delve into a scenario involving Navya, an employee at startup 'XYZ,' and explore how the current tax framework impacts her ESOP journey.

Scenario

Navya, one of the employees has received ESOPs at a startup XYZ

ESOP Grant Date

12th April 2018

ESOP Details

- Employer 'XYZ' grants Navya 10,000 shares through an
- Employee Stock Ownership Plan (ESOP).
  Price per share at grant (exercise price): Rs 50 per share.
- Vesting (lock-in) period: 4 years.
- Fair Market Value (FMV) at the time of grant (April 2018): Estimated to be Rs 75 per share.

Taxation at Different Stages

It is important to note that ESOPs are taxed in two instances: **at the time of exercise and at the time of sale of shares.**

Grant **(2018-19 Financial Year)**

- No tax is payable for the year 2018-19 on account of ESOPs because Navya has not yet purchased the shares. ESOPs are not taxable at grant.

Stage 2: Vesting Period **(April 2018 - April 2022)**

- Navya waits for the entire 4-year vesting period to pass before she can exercise her ESOPs.

Stage 3: Exercise **(April 2022)**

- After 4 years, in April 2022, the vesting period ends. Navya now decided to exercise the ESOPs and purchase all 10,000 shares.
- At this time, the FMV of the shares is estimated to be Rs 100 per share.
- The difference between the exercise price (Rs 50 per share) and the FMV (Rs 100 per share) is considered a perquisite for tax purposes.
- Rs 5 lakh (10,000 shares * (Rs 100 - Rs 50)) is added to Navya's income and taxed according to her income slab.
- Assuming Navya is in the highest tax bracket (30%), her tax liability is Rs 1.5 lakh (30% of Rs 5 lakh).

Budget 2020 Amendment
(Financial Year 2020-21 and Beyond)

- From the financial year 2020-21 onwards, an employee receiving ESOPs from an 'eligible' startup can defer taxes up to five years at the time of exercising the option, provided the shares are not sold, and the employee does not leave the company.
- Navya, in this case, is eligible for this tax deferral benefit as 'XYZ' is an eligible startup. She can choose to defer the taxes on the perquisite amount of Rs 5 lakh.

Sale of Shares (June 2023)

- In January 2023, Navya decides to sell all her shares at Rs 200 per share.
- Tax treatment depends on whether the startup 'XYZ' is listed or unlisted:

If 'XYZ' is a Listed Company

- Since Navya sold the shares after holding them for more than a year, Long-Term Capital Gains (LTCG) tax applies.
- LTCG tax rate is 10%, with gains of up to Rs 1 lakh exempt in a financial year.
- Total capital gains are Rs 10 lakh (10,000 shares * (Rs 200 - Rs 100)).
- Navya's LTCG tax liability is Rs 1 lakh (10% of Rs 10 lakh).

If 'XYZ' is an Unlisted Company

- Short-Term Capital Gains (STCG) tax applies since Navya sold the shares within two years of exercise.
- STCG is taxed at the applicable income tax slab rates.
- Total capital gains are Rs 10 lakh (10,000 shares * (Rs 200 - Rs 100)).
- Navya's STCG tax liability depends on her income tax slab rate.

Important Note

- ESOP taxation can vary based on the company's listing status (listed or unlisted).
- The Budget 2020 amendment allows eligible startup employees to defer taxes on ESOPs for up to five years, provided certain conditions are met.
- Employees should consider the tax implications and do due diligence when dealing with ESOPs, especially at Indian startups.

Employee Stock Ownership Plans (ESOPs) are not just a financial instrument; they represent a profound shift in the way employees engage with the companies they work for. They embody the spirit of partnership, aligning our interests with the success of the organisations we believe in. So, when you hold those ESOPs, remember that you're not just an employee; you're an owner, a stakeholder, and a contributor to a collective vision. Your journey with ESOPs is a testament to the belief that through dedication, innovation, and shared purpose, we can achieve remarkable feats.

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