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EMPLOYEE STOCK OPTIONS ("ESOPs")

Introduction

According to the book "Financial Market Analysis" by David Blake, "an option gives to its holder the right but not the obligation to buy or sell an underlying security at a fixed price (the exercise price or strike price) at or before a specific date (the maturity date or expiry date). This right is given by the issuer or writer of the option."

ESOPs are share options given to employees of the issuing company, giving them the right to buy its shares at a fixed price at or before a specific date.

Traditionally, ESOPs are reserved for top management because options were believed to offer shareholder status to employees in a position to have a meaningful impact on the performance of the company. Nowadays, ESOPs are offered to a wider range of employees so as to make many people shareholders in the future of the company.

Uses and benefits

The Singapore Government has identified employee share ownership as a key factor in facilitating the restructuring and development of Singapore's economy into the 21st century. The use of stock options was also highlighted last July by Deputy Prime Minister Tony Tan as an effective way to motivate and retain staff.

By making employees as shareholders, they will be motivated to achieve good results since they have a stake in the company. Ownership does tend to cause employees to be more aware of how their company is performing. The option plans can be designed such that the options can only be exercised after a certain period or the options are only given to employees who have worked for the company for a number of years.

ESOPs can also be used as a variable pay component. Companies can reward employees who achieve their performance goals with ESOPs, or they can be given only when certain criteria are met. Some companies call ESOPs incentive stock options or stock appreciation rights which they use to reward the entrepreneurial efforts of their employees.

An article in The Business Times (18 October 1999) “Start-ups seek stock options help” noted that local technopreneurs see ESOPs as a powerful recruiting tool because these high-tech start-ups "have nothing to offer people except an idea which they hope to turn into profit". They "can now dangle the carrot of possibly very large gains to attract the top talent they need".

Some companies preparing to list their shares on the stock exchange also use ESOPs to attract and galvanise employees to drive up companies' performances. There are various schemes used, eg. some may issue to senior management only while some may issue to all employees; some may impose a vesting period when employees have the promise of, but not access to, their shares.

Changes on Stock Exchange rules

The Stock Exchange of Singapore ("SES") has amended its rules on ESOPs or Share Option Schemes ("SOS") to make it more attractive in Singapore.

Some of the amended SES rules are as follows :-

1 SES has now allowed the following persons to participate in listed issuer's SOS :-

- non-executive directors of the listed group, and employees and directors of the listed group who are controlling shareholders and their associates;
- parent group employees (directors and employees of a listed issuer's parent group who do not hold positions in the listed group) who have contributed to the success and development of the listed group; and
- employees of an associated company provided the listed issuer has control over the management of the associated company.

2 The listed issuer can now decide to allow employees to participate in more than 1 scheme.

3 The exercise price can now be set at a discount to the market price, subject to a 2-year vesting period and provided that shareholders had specifically approved the maximum discount quantum. In the case of a main board listed issuer, the maximum discount is 20%.

4 The current rule providing that options may only be granted within a period of 42 days commencing from the 5th market day following the announcement of financial results, has been deleted.

5 Employees who have served less than 1 year of service in the listed group at the time of grant may now exercise the options any time after 1 year of the date of offer.

6 Unlisted subsidiaries of listed issuers are now subject to the same rules that apply to the listed issuers.

7 For main board listed issuers, the limit has been raised from 5% to 15% of the listed issuer's existing issued share capital. For SESDAQ listed issuers, the limits have been removed.

8 Director who participates in the scheme is now allowed to join as member of the Committee that administers the scheme of SOS. However, he should not be involved in the deliberations of the Committee in respect of individual options to be granted to him.

Taxation aspects

In Singapore, stock option gains are taxable in the year the option is exercised. It is viewed as a revenue gain because the options are made available to employees by virtue of their employment and therefore seen to be part of their remuneration package.

The amount assessable to tax is the excess of the open market value ("OMV") of the shares at the time of the exercise of the right over the exercise price. OMV is, in respect of listed shares, the last transaction price on the day of exercise; in respect of shares where the OMV is not available, for example, unlisted shares, it is the net asset value of the shares.

People are unhappy because they will be taxed on their "unrealised gain" at the point of exercising the options. It seems to contradict the principle of using ESOPs as an incentive when people are taxed on the gain which is still unrealised. Moreover, some employees may not be able to pay for the tax and consequently resort to selling the shares to cover the tax.

The Inland Revenue Authority of Singapore ("IRAS") now allows the tax payment for the gains from ESOPs of companies listed on the SES to be deferred for up to 5 years, from 1 January of the year of assessment for which the ESOP gains are assessed. IRAS has also clarified that ESOPs in respect of shares of companies listed elsewhere or unlisted companies will also qualify as qualified ESOPs if they satisfy the vesting period requirement imposed on companies listed on SES. The tax deferral scheme applies to options granted under a qualified ESOP which are exercised on or after 1 January 1999.

Companies need not apply for approval to qualify as ESOP but they need to keep sufficient documentation to show that the ESOP meets the vesting requirements and certify that the ESOP is a qualified one in the employee's application for tax deferral.

The employee can apply for tax deferral when he files his income tax return for the year of assessment in which the gains are taxable.

IRAS will consider the application only if :-

1 the employee is employed in Singapore at the time of exercising the option;

2 the option was granted by the company or an associated company for whom he is working at the time of the exercise; and

3 the employee's tax on ESOP gains is not borne by his employer.

IRAS will generally approve the application unless :-

1 the employee is an undischarged bankrupt; or

2 the employee is judged to be a delinquent taxpayer; or

3 the tax on ESOP gains is less than $200.

The amount of tax to be deferred is calculated by applying the employee's marginal tax rate to the ESOP gains (after deducting income tax rebate, if any).

Interest is chargeable on the deferred tax amount using a rate based on the average prime rate of the Big Four local banks on 15 April each year. The interest charge will commence 1 month after the date of assessment. The amount of tax deferred and the interest is payable on the expiry of the deferral period. However, early settlement of the deferred tax in one lump sum is allowed.

The deferral will cease and payment is due immediately in the following situations :-

1 a foreign employee, including Singapore Permanent Residents, terminates his employment in Singapore and leaves the country, is posted overseas or leaves Singapore for a period of more than 3 months; or

2 the employee becomes bankrupt; or

3 the employee passes away, in which case the tax will be recovered from his estate.

With the new SES and IRAS rules, ESOP is now more attractive and may be more acceptable to the employees of listed issuers in Singapore.

Conclusion

ESOPs are good reward strategies, which can motivate and retain talents. They are also less risky to the employers. US stock options specialist William Scott Jr notes that options allow the company "to pay for employee motivation with less risk" compared to cash or stock bonuses. This is because the "bonus risk" is transferred to the employees.

References

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(4) The Business Times, 18 October 1999 , 25 October 1999 & 3 December 1999
(5) Singapore Accountant - July/August 1999 (Employee Stock Options - Taxing Issues)