**ESOP PRIMER**

**INTRODUCTION TO EMPLOYEE INCENTIVE PLANS**

**Overview**

This article sets out a high level overview of certain types of employee incentive plans commonly used among start-ups in Singapore, and the key factors to consider in designing and implementing such plans.

Under an employee incentive plan, a participant (who could be the founder, an employee, a consultant or an officer of the company) is rewarded for meeting prescribed benchmarks or key performance indicators ("**KPIs**"), usually in the form of cash or shares (or options or other instruments convertible into shares). Such incentives are intended to recognize and reward participants for their contributions and/or motivate them to work to the best of their abilities. They are used by start-ups to attract and retain talent by supplementing compensation packages that may otherwise be viewed as less attractive than those offered by larger or more established companies.

It is important to note that many of the concepts explained below are generalized observations of common approaches found in the Singapore market. The structure, type and terms of an employee incentive plan can vary greatly depending on, among other things, the business and commercial objectives of the company and the participants, as well as legal and tax considerations (which differ across jurisdictions). Companies should seek appropriate legal and tax advice in structuring, documenting and implementing their employment arrangements.

**Types of Incentive Schemes**

In Singapore, the types of incentive plans offered by start-ups may include the following:

* **Employee share option plan** ("**ESOP**"): This is the most common form of share incentive scheme for start-ups in Singapore. Under an ESOP, the participant is awarded an option to purchase shares of the company in the future at a pre-determined exercise price. The options are typically subject to vesting conditions (i.e., the participant will only be eligible to exercise the options to purchase shares of the company upon the satisfaction of agreed conditions such as the completion of agreed periods of service or the achievement of KPIs), transfer restrictions (e.g., the options and shares cannot be sold or transferred during certain time periods or to certain types of people / entities), and forfeiture or repurchase by the company (e.g., upon leaving the company, the participant may have to return the shares or sell them back to the company at a stipulated price).
* **Employee share ownership scheme (**"**ESOS**"**)**: Under an ESOS, a participant is issued shares of the company instead of options. Participation in an ESOS is typically reserved for founders or key employees of a company in order to limit the number of shareholders. Similar to an ESOP, a share issued pursuant to an ESOS is typically subject to vesting conditions, transfer restrictions and forfeiture.
* **Cash incentive schemes**: Under a cash incentive scheme, cash is paid to a participant when the participant has achieved the relevant KPIs. Singapore law does not prescribe a maximum or minimum cash incentive amount, and the company generally has the discretion to determine the amount to be awarded to a participant. The cash awards would normally be taxed as employment income and Central Provident Fund contributions are payable to employees.
	+ Under a cash incentive scheme, a participant does not receive equity and therefore does not participate in the equity "upside" of the business, which is the key advantage of a share incentive scheme that helps to align the participant with the long-term interests of the company's shareholders.
	+ One way of addressing this is by paying the participant a cash amount that mimics the economic upside that the participant would otherwise receive in a share-based incentive scheme. A phantom share plan is a well-known example of such a scheme.

This article focuses on share incentive schemes.

**Key Singapore Tax Considerations**

This section sets out a high-level summary of certain key Singapore tax considerations relating to an ESOP or ESOS administered by a Singapore company for Singapore resident employees. Further details of the Singapore tax considerations can be found in an [e-Tax Guide](https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguides_IIT_ESOP_2013-6-24.pdf) issued by the Inland Revenue Authority of Singapore ("**IRAS**"). If the plan is intended to benefit participants from other jurisdictions, foreign tax implications should be considered as well. While it is not uncommon for plan documents to provide that personal taxes arising from a grant would be borne by the participant, founders and/or employees who receive particularly large grants may wish to seek tax advice as early as possible in order to help achieve the desired tax treatment.

* **Considerations for the company**:
* A company may be eligible for corporate income tax deductions in respect of certain costs incurred in relation to shares or options granted to employees under an Employee Equity-Based Remuneration Scheme if it meets certain conditions, as detailed in a separate [e-Tax Guide](https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguides_IIT_Tax%20Deduction%20for%20Shares%20Used%20to%20Fulfill%20Obligations%20under%20an%20Employee%20Equity-Based%20Remuneration%20Scheme_2018-04-10.pdf) issued by IRAS.
	+ Tax deduction does not apply to plans fulfilled by way of issuance of new shares (since no cost is involved in acquiring the shares).
	+ Tax deduction may be available on cost incurred to acquire treasury shares (as defined) transferred to the employees under an Employee Equity-Based Remuneration Scheme. Note that certain deduction formula may apply.
* **Considerations for the participants**: In respect of shares or options granted on or after 1 January 2003 under any ESOP or ESOS, the gains derived from such ESOP or ESOS are taxable if the shares or options are granted while the employee exercises employment in Singapore. This is regardless of where the employee is at the point of exercising the ESOP or at the point of vesting of the ESOS. This applies even if the employee exercises the options after the employment in Singapore has ended, the shares vest after the employment in Singapore has terminated, or the employee is posted overseas. There is a deemed exercise rule when a foreigner ceases employment or a Singapore Permanent Resident employee leaves Singapore permanently, as discussed below.
* **Timing and amount of taxation of ESOP and ESOS gains to the participants**:
* Gains from an ESOS grant with no vesting imposed are taxable in the year that the shares are granted.
* Gains from an ESOP or ESOS granted on or after 1 January 2003 with vesting imposed are taxable in the year of occurrence of the applicable event set out below:

|  |  |  |
| --- | --- | --- |
|  | ESOP | ESOS |
| Without selling restriction | The individual exercises the ESOP | The shares under the ESOS are vested on the individual |
| With selling restriction | The applicable taxing point described above may be deferred until the selling restriction is lifted |

* Generally, the taxable gain is computed as the difference between the price paid by the participant for the shares (if any) and the open market value of the shares as of the date of the applicable event described above.
* As noted above, the gains are not taxable on disposal of the shares. Hence, consideration should be given to aligning the timing of the crystallization of tax liability and the expected capital gain from an exit event so that the participant is not out-of-pocket in terms of tax payable or required to pay tax on a potential capital gain that might not occur. Subject to conditions, employees can choose to defer the payment of tax (subject to an interest charge) on the gains for up to a maximum of five years.
* **"Deemed exercise" rule**: Foreign participants may be subject to a "deemed exercise" rule in the event their employment in Singapore is terminated. In the case of a foreign participant who holds Singapore Permanent Resident status, the above rule applies when the participant leaves Singapore permanently or is posted to work overseas. Under the "deemed exercise" rule, all unexercised ESOPs and unvested / restricted shares granted under an ESOS are deemed to have been vested / exercised one month prior to the date of cessation of employment or departure from Singapore. The final gains are deemed to be income derived by the employee one month before the date of cessation or the date of the grant, whichever is later. The employer is required to furnish details of the final gains when it seeks tax clearance for such employees. A refund may be claimed within a prescribed period if the actual gain is less than the gain assessed under the deemed exercise rule. It may also be possible to obtain a waiver of the above "deemed exercise" rule if the company elects to track the gains and certain requirements can be met.

**Key Features and Considerations**

Aside from tax, other key features and factors to consider when designing a share incentive scheme include the following:

* **Eligibility of participants**: The company should identify the intended types and number of participants of the share incentive scheme. This will allow the company to determine if there are any regulatory considerations that would apply. For example:
	+ The number of members of a Singapore private limited company is capped at 50, but members who are current employees as of the time they acquire the shares are not counted toward such 50-person limit. If the company intends to have more than 50 members, it should work with legal and tax advisers to explore solutions that achieve the desired outcomes for the company and its employees.
	+ An issuance of shares may be subject to securities offering rules (including a requirement to prepare and file a prospectus) unless exemptions apply. A share issuance to employees is an example of such exemptions. If the incentive shares are intended to be issued to non-employees (e.g., consultants or service providers), the company should explore whether other exemptions are available.

Further, the size of the share "pool" to be reserved for the scheme (see below) may depend in part on the intended number of participants. The company may also wish to develop a set of criteria that a participant should satisfy in order to be eligible for a given scheme.

* **Vesting**: Share incentive schemes typically include a vesting period, which refers to the period of time before the options become exercisable (in the case of an ESOP), or the shares become fully owned (in the case of an ESOS), by the employee. A vesting period helps to facilitate employee retention and incentivize continued contribution by the employee to the company. In setting the vesting period, various factors should be taken into account, including the age of the company, the vesting period in an existing incentive plan (if any), the size of the ESOP or ESOS pool, the seniority and length of service of the participant(s), and other factors as described below.
	+ One example of a vesting period would be four years with a one-year "cliff". Under this construct, 25% of the shares or options vest after one year (starting from the day the employee joins the company, if granted to a new hire) and the remainder vests in equal monthly or quarterly installments over the next 3 years. If, during the one-year cliff period, an employee resigns from the company or the employment is otherwise terminated, the employee will not be entitled to any shares or options. Thereafter, if an employee leaves during one of the monthly or quarterly vesting periods, the employee will generally only be entitled to rights that have already vested as of the last date of employment.
	+ Other types of vesting schedules include back-loaded vesting which increases year after year (e.g. 10% in the first year, 20% in the second year, 30% in the third year and 40% in the fourth year), or performance-based vesting schedules where the shares or options only vest if the employee or the company achieves certain pre-determined KPIs. These KPIs should be in line with the company's commercial and business goals, and set with a view of enabling the share incentive scheme to function effectively as a motivator for the employees.
* **Quantum and exercise / strike price**: This refers to the amount of money to be paid by the employee to the company when exercising the options. In Singapore, it is not uncommon to see the exercise price set at a price that is close to the share's fair value at the time the option is granted (for example, the last round's valuation or a small discount to such valuation).
	+ Factors that should be taken into account when setting the exercise price include tax implications (including the time at which tax will be levied and the amount of tax that the employee has to pay), the motivational effect on an employee, the ability of the employee to fund the exercise price and tax payments, and the size of the share "pool" to be reserved for the scheme (see below).
	+ A balance has to be found between these inter-related and often competing considerations. For example, in the case of an option, a low exercise price will confer more upside (being the difference between the exercise price and the value of the shares at the time of exercise) and require less cash to exercise the option, but will result in higher taxes for the employee (as a result of the higher upside). Conversely, a high exercise price would confer less upside and require more cash to exercise the option, but lower taxes.
* **Size of share / option pool for incentive scheme**: Another consideration would be the number of shares in the capitalization of the company to be set aside for the share incentive scheme. This is often a matter of commercial negotiations between the company and its investors given the dilutive effect such pool would have on the shareholders and investors of the company, and would take into account the valuation of the company, amount of capital being raised at the funding round (if applicable), the stage of growth of the company and its business, and other factors as set out elsewhere in this article. For example, a start-up may initially set aside a pool in the range of 5%-10% of the total share capital of the company on a fully diluted basis and refresh (i.e., top up) or expand (for example, to 15-20% at later funding rounds) the pool at each round of funding to facilitate the continued incentivization of employees.

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* **Transfer and voting restrictions**: Shares and options granted under an ESOS and ESOP, respectively, typically come with terms that govern transfers and the exercise of voting rights. Among other transfer restrictions, a transfer of the share or option would usually be subject to prior board or shareholder approval. If the shares issued under a share incentive scheme are voting shares, the employee may be required to grant a voting proxy and/or power of attorney in favor of an employee representative to prevent the pool of voting shareholders from becoming overly dispersed, thereby raising administrative issues when collecting votes in respect of a shareholder resolution (among others). Another way to address this concern is to issue non-voting shares under the share incentive scheme or provide for legal title to the shares to be held in a share management trust. A company may also consider incorporating a power of attorney in the terms of an ESOS or ESOP to allow an attorney (usually the founder or a director of the company) to exercise the rights under the shares and options granted under an ESOS and ESOP, respectively, which would help to, among other things, facilitate an orderly exit (e.g., to avoid having to chase down the signatures of participants who might have left the company at the time of an exit).
* **Forfeiture and repurchase**: The terms of the share incentive scheme would typically contain terms allowing a company to repurchase the shares owned by the employee, or requiring the forfeiture of unexercised options or shares, upon the occurrence of stipulated events such as the departure of the employee (including in a bad leaver situation, in which case the shares may be repurchased for a nominal amount). This is to help ensure, among other things, that the shares reserved for the share incentive scheme remain in the hands of the company and its employees, serving the objective of aligning the interests of the company's shareholders with those of its employees as intended. Consideration has to be given to how the repurchase is facilitated since share buybacks require shareholder approval under the Companies Act, are subject to limits (i.e., 20% of issued share capital for the period between the resolutions approving such buybacks and the next annual general meeting, for Singapore companies), and must be repurchased out of the profits or capital of the company (both of which start-ups may not have). Additionally, the price for the repurchase has to have some regard to the fair market value of the shares lest the repurchase be unenforceable as a penalty.
* **Acceleration of vesting upon change of control**: The terms of the share incentive scheme may provide for an acceleration of the vesting schedule (i.e., all unvested shares or options become vested) upon a change of control of the company. There are two main types of acceleration:
	+ In a single trigger acceleration, unvested shares or options become partially or fully vested upon the occurrence of the change of control.
	+ In a double trigger acceleration, the vesting would require (1) the change of control, and (2) the occurrence of certain qualifying terminations of the employment (e.g., an involuntary termination by the company or successor entity) occurring within a prescribed period (typically 1 or 2 years) after the change of control. Compared to a single trigger acceleration, a double trigger acceleration is usually preferred by an acquirer because it helps to align the employee, the company and the acquirer by incentivizing the employee to stay with the company following the change of control.

Acceleration does not necessarily have to be provided in all share incentive schemes. Such an arrangement is usually negotiated based on the specific circumstances of the company as well as its founders and key employees, and often come up as a negotiation point with the acquirer in a change of control of the company.

* **Cash settlement:** The rules of an ESOP may contain a cash settlement clause which allows the company or the administrator of the scheme, in an exit transaction of the company, to cancel vested options in exchange for an amount of cash payable to the participant which is equivalent to the fair market value of the shares (usually pegged to the quantum of exit proceeds) otherwise issuable upon the exercise of such vested options. Such a "cash settlement" right may be exercised upon the receipt of a binding exit offer, so that the company does not need to involve numerous employee shareholders in the exit transaction process.
* **Leaver provisions:** An ESOP typically lapses when an employee leaves the company, but ESOP terms could allow for an option to be exercised early for good leavers, or allow the employee to retain part of the option until it becomes exercisable. These can be aligned with the leaver provisions (if any) in connection with the shares held by the founders and/or key employees of the company.

**Share Incentive Schemes - Implementation**

Below is a summary of the key steps and documentation required to implement a share incentive scheme in Singapore.

* **ESOP / ESOS rules**: This is the key document that sets out the terms and conditions governing the shares or options granted under the plan, many of which have been discussed above. The rules would include a form of the letter that grants the shares or options (as applicable) and, in the case of an ESOP, a form of the exercise notice for the options.
* **Board and shareholder approval**: The directors and shareholders of the company will need to pass the applicable resolutions approving the ESOP / ESOS rules, the size of the pool, the grant of the shares (requires board and shareholder approval) or options (requires board approval), and, in the case of an ESOP, the issuance of shares on the exercise of the options (requires shareholder approval).
	+ Instead of seeking shareholder approval for each share issuance, the directors of the company would typically seek a "general mandate" from the shareholders under section 161 of the Companies Act 1967 to issue multiple tranches of shares within a given period (usually yearly).
* **Granting the shares / options**: The board should approve, typically by written resolutions, each grant of the shares or options and issue a grant letter to the grantees, which sets out the number of shares or options granted, the exercise price (in the case of options), and the vesting schedule. The company should maintain registers to keep track of all the shares and options granted, the exercise and expiry dates (in the case of options), and the vesting schedule.
* **Other corporate formalities**: Finally, the company should review its constitutional documents to help ensure any consent or other requirements thereunder are addressed. For example, if the constitution and/or shareholders' agreement of a company contains pre-emption rights on issuance of new shares or requires specific shareholders' consent to be obtained for the implementation of a share incentive scheme, these rights would need to be waived or such consents would need to be obtained (as applicable) in order to effect the proposed issuances under the share incentive scheme.