The importance of Phantom Stock

Introduction

The recent developments in the e-commerce industry and startup revolutions have created immense competition among the employers to recruit and retain talented employees. Moreover there are array of job opportunities among the talented employees to choose from. Hence, it has become essential for companies not only to offer high remuneration packages but also attractive incentives to employees, primarily key managerial personnel and senior management to retain them and not lose them to their competitors in the long run.

Such incentives include employee stock option schemes and employee purchase plans, stock appreciation rights, general employee benefit schemes and retirement benefit schemes. These incentives enable the organization to improve the performance capabilities of employees and transform them to growing partners. One such incentive granted to employees and other people in the organization is Phantom Stock.

What is Phantom Stock

Phantom stock also known as *shadow stock, simulated stock or Phantom Shares* is a contractual agreement between a corporation and recipients of phantom stocks, that bestow upon the grantee the right to a cash payment at a designated time or in association with a designated event in the future, which is to be an amount tied to the market value of an equivalent number of shares of the corporation's stock.

Like other forms of stock-based compensation plans, phantom stock broadly serves to align the interests of recipients and shareholders, incent contribution to share value, and encourage the retention or continued participation of contributors. Phantom stocks' rise and fall in value is in line with the underlying company stock, and persons owning the stocks are compensated with company’s stock appreciation at a specific date.

Companies use phantom stocks both as a motivational tool to reward employees and to give those employees “skin in the game” to increase workplace productivity and earn the company more profits - a formula that drives the company’s stock price higher, as well.

Importance of Phantom Stock

Wealth maximization shall be one of the important objectives of every business. In that process, employees are the crucial part as they form the back bone of any business. By distribution of phantom stocks, both employees and employer would involve in the process of long term wealth creation. It benefits the employees and employer in the following ways.

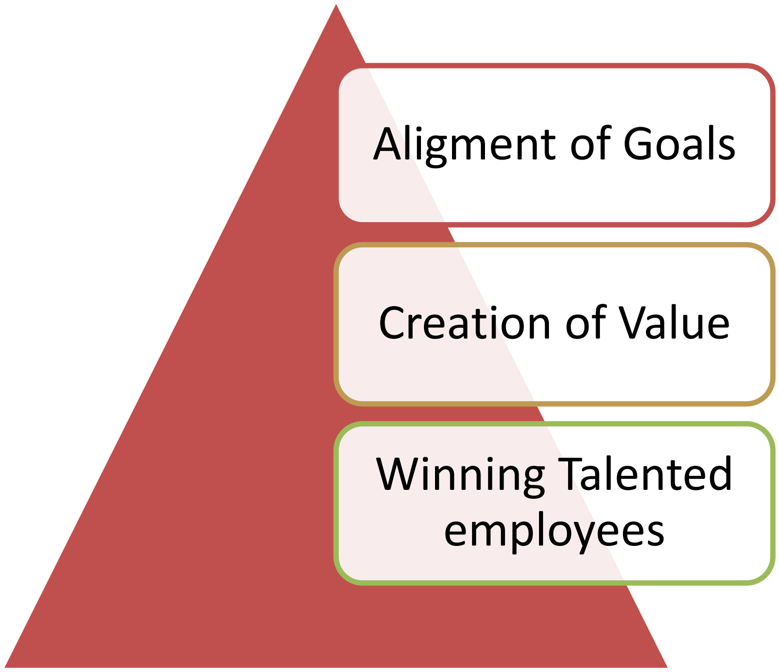
Employees:

Phantom stocks reward the time and effort employees invest into the company. When the phantom stocks mature, company shall pay cash equivalent of the shares; this shall act as a source of motivation for the employees to work harder and put relentless efforts in their course of employment.

Employers:

For company owners, phantom stock can help grow their business. Strong leadership is essential to a company's success, and replacing senior leadership can be expensive. Phantom stock gives top employees a reason to stay and help the company succeed.

Some of the outcomes of the phantom stock plans are as follows:



Advantages and Disadvantages of Phantom Stock

Every employee benefit plan shall have certain advantages and disadvantages; similarly phantom stock plan also has its own advantages and disadvantages

Advantages:

Disadvantages:

Types of Phantom Stock Plans

There are three different types of Phantom Stock Plan as follows:

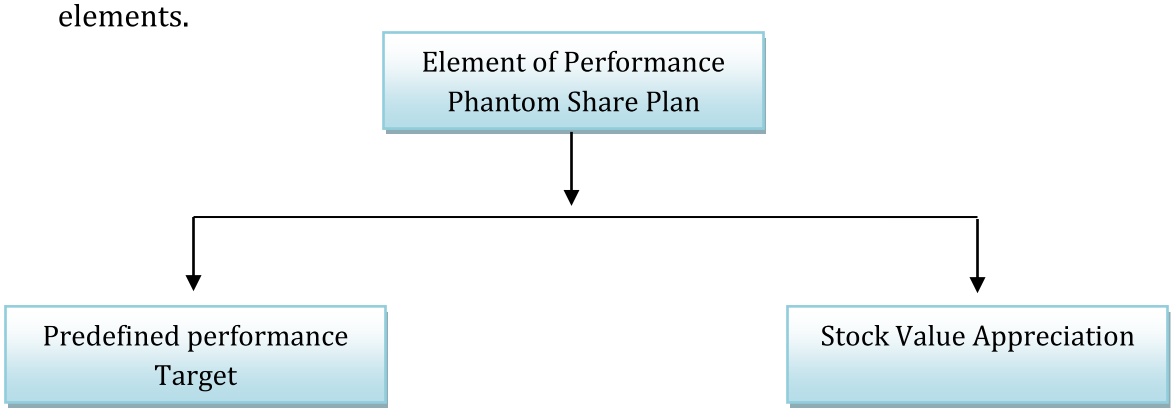
i. Full Value Stock Phantom Plan

A Full Value Phantom Stock Plan is a deferred cash bonus program that pays out exactly the stock's worth at the time of cash settlement of the stock.

Employees are awarded some number of phantom stocks that carry specific terms and conditions. At some point in time, active employees will receive a cash payment equaling the value of the original shares plus the appreciation thereon.

ii. Performance Phantom Share Plan

A Performance Phantom Share Plan contains two distinct performance-based elements.



- **Predefined Performance Target:**
  Employees are promised to receive phantom stocks upon fulfillment of certain pre determined financial goals. The predetermined financial targets might include such measures as Pre-tax Income, EBITDA, increase in turnover to a prescribed target, etc.

- **Stock value appreciation:**
  The second performance element relates to the potential improvement in value that may come through phantom stock value appreciation.

iii. Phantom Stock Option Plan

Phantom stock options ("PSOs") are those options which are settled by way of cash settlement. It is a performance based incentive plan through which an employee is entitled to receive cash payments after a specific period of time or upon reaching a specific target. This is directly linked to the value of the company's share price.

The most common phantom stock plans amongst the above are Full Value Plans and Phantom Stock Options also known as "appreciation only" plans.

Phantom Stock vs. Real Stock or ESOP

Both Phantom stock and ESOP are employee benefit programs that work towards employee satisfaction, motivation and retention of talented employees. These programs not only provide the employees with financial security but also nurture the sense of commitment responsibility towards the organization. However there are certain differences between ESOP and phantom stocks which are explained as below:

Particulars	ESOP	Phantom Stock
Dilution	Ownership of the company is diluted	Ownership of the company is not diluted
Participation	Employees get the right to participate the management of the company	Employees do not acquire any right to participate the management of the company
Initial Payment	Employees have to initially pay some price for acquisition of ESOP	Employees need not pay anything to the company.

The major drawback with ESOP is that instead of having one owner, the entity would have a cadre of owners, which makes key business decisions even difficult. And, ultimately, after creating the ESOP, when the promoter decides to sell the company to an outside buyer, he/she now has a second set of owners who will need to approve the sale.

Phantom stock or phantom equity is a method that allows you to give your employees shares of non-voting stock, which they can redeem later, usually when the company is sold or when the employee retires (assuming the employee is fully vested). Unlike traditional shares that need to be repurchased when an employee leaves or is terminated, phantom shares essentially loses its existence once employees discontinue with the organization.

Taxation of Phantom Stocks in Few Countries

Country	Employee	Employer
India	At the time of exercise of Phantom Stock, it shall be taxed under salary (perquisites) at the applicable slab rates.	The employer shall be liable to deduct tax on the same.
USA	Employees are taxed when the benefit of Phantom stock is	The employer shall be liable to deduct tax on the same.

	exercised. The taxable value shall be the value of reward, reduced by any consideration. This taxable value shall form part of the ordinary income of the recipient.	
UK	No tax is payable on the grant of a phantom option but any payouts made under a Phantom stock plan will be subject to income tax through PAYE (Pay as you earn system) and national insurance contributions (NICs)	-
Russia	Income tax on vesting, on the fair market value of shares	When the benefit of Phantom stocks is structured through the payroll of employees, employers shall be liable to withhold tax.
China	No concept of Phantom Stocks prominent; the employees have to purchase shares (at agreed rate) in case he is offered participation in an employee share plan. The employee is taxed on the amount that constitutes the difference between the market value of the shares and the amount paid by the employee for acquiring	The employer shall withhold and remit personal income tax on behalf of the employee.

	the shares. This amount is treated as part of the employee's salary income and taxed according to the individual's income tax rate.	

Conclusion

Even though Phantom stock is highly advantageous and globally a popular practice, it has not evolved as a practice in India. Employees usually prefer ESOPs as it gives them a stake in the company, thus, a higher impetus to be involved in the company's growth. With the growing start-up revolution, most companies go through the conventional method issuing ESOPs as a motivator for its key employees to ensure their long-term loyalties to the company and curb attrition. However, Phantom stocks would serve to be highly advantageous if the company chooses to employ this method rather than ESOPs as it would preserve the ownership and the decision making power of the company.

DVS Advisors LLP is a member of MSI Global Alliance, a leading international association of independent legal and accounting firm. DVS Advisors LLP is a contemporary tax, legal and financial solutions provider with a specific focus on Direct, International and Indirect Taxation. For further information visit the firm's website: www.dvsca.com