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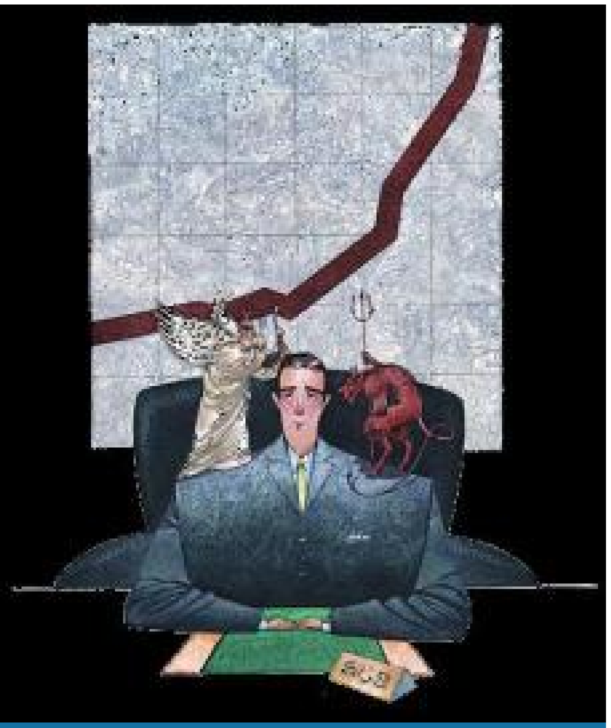

Phantom Share Options

Incentivising employees when company shares are unavailable

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Introduction

Incentivising employees is top of the agenda in many companies across the UK. Granting share options – the right to acquire shares on some future date at today's price – is one of the many ways to reward employees for good performance and loyalty since it links corporate profitability with personal reward.

However, in many instances, it isn't possible to implement a share option scheme – either because the company has no shares available for issue (such as where a venture capital investor is unwilling to dilute its shareholding) or because the company is unquoted and there is no market in its shares. One danger of conventional share option plans is dilution of the interests of the existing shareholders and possible depression of the market price on exercise of options if the shares are listed.

The solution, particularly for larger privately owned companies, may be to implement a phantom share option scheme. Phantom share options are rights to receive a deferred cash bonus where the amount of the bonus is linked to the increase in the value of the company's share price between the date of grant and the date of exercise of the phantom share option. Apart from creating the opportunity for employees to participate as quasi shareholders in circumstances where holding actual shares isn't possible, a phantom share option scheme has other advantages:

- From the company's point of view, the administrative difficulties arising from having a number of employees holding small shareholdings are eliminated – there is no dilution of existing shareholders, no creation of minority shareholdings and no need to create an internal market or buy-back arrangements for employees holding unmarketable shares.
- The amounts paid by the company are offset against taxable profits of the company.
- There is no benefit in kind on "issue" of the notional phantom shares (although income tax and national insurance is payable on the bonus paid out).
- There is no dilution of the issued share capital as no share is transferred to the executive on exercise of the option.
- As the amount of the bonus is linked to the increase in the share price, the employees' interest and that of the shareholders are aligned and their common objective becomes the addition of value to the company.
- The company may reserve the right to apply some or the entire cash bonus, in subscribing for new shares on behalf of the employee e.g. where there may be a cash flow problem or where the employer wants to bind the employee in.
- There are no regulatory requirements to be met and the scheme can be very flexible – however, the company should establish a policy in connection with the grant of shadow share options. The policy should cover matters as to which employees should be granted options and the conditions which should be attached to those options.

The main disadvantages are:

- As the company makes a cash payment, the timing of which is at the individual's discretion and not the company, there will be a cash flow cost - the company should always consider whether it should grant options with an open-ended commitment as to the amount of bonus which may become payable when the options are exercised. It is fairly common to place a cap to limit the amount of bonus which is payable.
- National insurance contributions are payable – this increases the cost to the company.
- The bonus is chargeable to income tax in the hands of the executive.

How Phantom Share Options Work

A phantom share option scheme is a scheme through which employees are allocated "shadow options". But no actual "shares" as such are issued or put under option at all. As with other option schemes, the "options" are converted into shares (albeit "shadow shares") when the options are exercised. A phantom share plan is thus a deferred cash bonus scheme calculated by reference to the increase in market value of a fixed number of shares over the option period.

The scheme can include any conditions and limitations since it is not bound by the rigid regulations that apply to HMRC approved share option schemes.

At the end of a certain period, and/or in the event of the sale or listing of the company, the board of directors will convert the shadow options allocated to employees into shadow shares. The value of each shadow share granted to employees might be the

What is a Phantom Share Option?

A phantom share option scheme is a cash bonus scheme under which the amount of the bonus is determined by reference to the increase in value of the shares subject to the option. No shares are actually issued or transferred to the option-holder on the exercise of the phantom share option.

equivalent of the value of each company's share at that time using the growth in value of the company shares as a measuring tool. Thus, at the event of the sale of the company, the employees will receive the cash equivalent to that which they would have received had they been the actual owners of real shares rather than phantom shares.

The money paid out to employees is treated as emoluments and is subject to the application of PAYE income tax and national insurance. It is also a tax-deductible expense to the business.

The Taxation Perspective

HMRC's Share Schemes Manual contains full guidance about schemes that involve the actual transfer of shares to employees. However, some employers set up incentive schemes which involve the award of "phantom" or hypothetical shares. In schemes of this type the employee is given an award which represents a specified number of units, or shares, in the employer's company. At the time of the initial award the employee does not receive money, or any form of "money's worth". There is therefore no "emolument" and no charge under Section 19(1)1 ICTA 1988 at the time of the initial award. All the employee actually gets is the prospect of receiving a cash payment at some time in the future.

The employer's objective is to encourage the employee to continue in the employment, and to provide an incentive for the employee to work well, by holding out the prospect of a future bonus payment linked to the value of the company's shares.

The details may vary from scheme to scheme. Typically, and provided that the employee remains with the company, he or she eventually receives a cash payment equal to the value of the "phantom" shares at the time of payment. This is likely to be greater than the value at the time of the original award. The cash payment is an emolument chargeable under Section 19(1)1 in the year that the employee receives it. It is usually, though not invariably, an emolument for that year.

A phantom share option scheme works in the same way as an HMRC approved company share option plan. The employee is granted an option over a number of shares at an option price that is usually (but not necessarily) equal to the market value of a share at the date of grant of the option. When the employee exercises the option, he simply gets a cash bonus which, subject to the rules of the scheme, is equivalent to the difference between the market value of the shares at exercise and the option price.

Further Information

HMRC provides useful information about the tax status of phantom share schemes:
www.hmrc.gov.uk/shareschemes/news/phantom-share-plans.htm
www.hmrc.gov.uk/manuals/eimanual/EIM01600.htm
www.hmrc.gov.uk/manuals/senew/SE01600.htm

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

If you'd like to talk about setting up a phantom share scheme for your company or if you would like to receive further information about this subject or other publications, please call us – see our contact details on the next page.

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AaronWallis™ Sales Recruitment

Aaron Wallis hopes that you have found this document useful. We are a specialist sales and marketing recruitment agency with offices in Milton Keynes, London (Victoria), Leeds and Bristol.

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