De Jure

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Phantom Stock Option – An effective tool to incentivize Employees

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Phantom Stock Options are becoming increasingly popular as they enable companies to share a portion of their profits or appreciated valuation, thereby incentivising and retaining employees in such a manner that does not result in a dilution of the shareholding of such companies.

Employees are critical to the growth and success of any organisation. The recent times have witnessed a start-up deluge and booming e-commerce which, coupled with increased opportunities and prevailing competition, have resulted in higher levels of attrition. This has necessitated companies to offer to their employees, particularly senior and key employees, attractive remuneration packages and incentives so as to retain the employees in the long run. These incentives and benefits include employee stock options and stock purchase plans, stock appreciation rights, other general benefits, retirement benefits etc.

ESOPs – A conventional mode of employee incentive

Among the various incentives and benefits offered to the employees, employee stock option and stock purchase plans ("***Stock Plans***") are one of the most effective tools, traditionally utilised for retaining employees within the organisation. Stock Plans, as the nomenclature suggests, entitles an eligible employee to an equity stake in the company. Upon fulfilment of defined criteria, the employee becomes eligible to subscribe to, or purchase, specific number of shares at a pre-determined price. While the Stock Plans formulated by listed companies in India are specifically governed by the Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 ("***SEBI Employee Benefit Regulations***"), the Stock Plans formulated by unlisted companies are governed by Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 ("***Companies Act ESOP Provisions***"). Both these enactments contain detailed provisions on the introduction and implementation of Stock Plans by listed and unlisted companies.

SARs - A contemporary mode of employee incentive

ESOPs have been the conventional mode of a deferred reward plan for employees. However, a number of factors including specific preferences and requirements of companies coupled with the need to evolve traditional concepts to meet the changing pace of time, have lead to the introduction of hybrid incentive plans which also include stock appreciation rights ("***SARs***"). SARs, as the name suggests, entitles an employee to receive appreciation, for a specific number of shares of a company where the settlement of such appreciation may be made either by way of cash payment or shares of the company. Thus, SARs granted to employees results in two forms of underlying entitlements at the time of exercise of SARs by the employees, one form being equity stake in the company and other being a cash entitlement. SEBI Employee Benefit Regulations specifically mentions that SARs which are settled by way of shares of a company are referred to as equity settled SARs.

The concept of Phantom Stock Options

'*Phantom Stocks Options*' or '*Shadow Stocks Options*' ("***Phantom Stock Options***") is a popular nomenclature derived from usage for SARs which are settled by way of cash entitlement. A Phantom Stock Option is a performance-based incentive plan which entitles an employee the right to receive cash payments after a specific period of time or upon fulfilment of specific criteria and is directly linked to the valuation and the appreciated value of the share price of the company. Thus, the underlying entitlement for an employee at the time of exercise of Phantom Stock Options is a cash payment unlike the Stock Plans which entitles an employee to an equity stake in the company. Thus, while Phantom Stock Options may be beneficial to companies and its management (*read employers*), they may not be an attractive option for employees who may be seeking an equity stake in the company in the form of Stock Plans or equity settled SARs as against a cash incentive.

Tax Implications of Phantom Stocks

The income received by an employee, in the form of cash entitlement at the time of the exercise of Phantom Stock Options, is taxed under the head of salary income as perquisites in the hands of the employee. No incidence of the tax arises in hands of the company (*read the employer*) at the time of making payment of the cash entitlement to the employee. However, considering that the cash entitlement received by the employee upon the exercise of the Phantom Stock Options is taxed under the head of salary income, the company is required to withhold taxes (*read tax deducted at source*) just before making payment of the cash entitlement to the employees.

Legal Framework for Phantom Stock Options

Under the Companies Act 2013: While the Companies Act, 2013 has prescribed rules for issuance of shares to employees under Stock Plans, it is silent on the grant and exercise of SARs including issuance of equity settled SARs and Phantom Stock Options.

Under SEBI Employee Benefit Regulations: The SEBI Employee Benefit Regulations read with the Companies Act ESOP Provisions prescribe rules and regulations for formulation of Stock Plans and the grant and exercise of equity settled SARs by listed companies.

Informal Guidance sought by Mindtree Limited: It would be interesting to mention here that with respect to SARs, SEBI has, by way of its informal guidance sought by Mindtree Limited, clarified that one of the criteria for determining the applicability of the SEBI Employee Benefit Regulations to an employee benefit scheme is that such scheme should actually involve "*dealing in, or subscribing to, or purchasing, securities of the company directly or indirectly*".

SEBI has further stated that if the proposed scheme does not involve dealing in securities of the company, directly or indirectly, then the SEBI Employee Benefit Regulations are not applicable to the scheme. The employee benefit scheme of Mindtree did not involve a purchase or subscription of shares by eligible employees at the time of the exercise of the right, but was in the form of cash payments for appreciation in the share prices of the company and SEBI clarified that the SEBI Employee Benefit Regulations would not be applicable to Mindtree employee benefit scheme. However, considering that the views contained in the informal guidance relating to Mindtree are specific to facts and clarification sought by Mindtree, the views expressed by SEBI in the Mindtree informal guidance cannot be applied generically.

Existing Indian legal framework is silent

The existing Indian legal framework is silent on the grant and exercise of Phantom Stock Options. Hence, till such time that specific provisions are introduced under the Companies Act, 2013 or until the Securities and Exchange Board of India amends the existing regulation on employee benefits to bring Phantom Stock Options within its purview, companies will have the liberty of formulating schemes for the grant and exercise of the Phantom Stock Options in a manner as they may deem fit.

The concept of Phantom Stocks assumes more relevance in the context of the Covid-19 pandemic when not just economies but businesses are also being impacted and uncertainty has taken forefront. Considering that the premise of a Phantom Stock Option plan is deferred payment of cash compensation to employees by the employers, Phantom Stock Options perhaps may start emerging, as one of the most effective options for Indian companies to incentivise and retain employees that would aid in addressing both, employee job retention and organisational talent and skill retention challenges.

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