BUDDLE FINDLAY

Phantom equity – better than the real thing?

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In recent years employee equity schemes have been a popular way for companies to attract, incentivise and reward their staff – and this is a trend that shows no signs of slowing. However, we have seen a clear evolution in thinking about the preferred employee equity scheme structure. Once unpopular, phantom share schemes are emerging as a scheme structure of choice due to their flexibility.

A little bit of history

Any company proposing to establish an employee equity scheme must determine whether its objectives for the scheme will be best met by a share scheme, an option scheme or a phantom or shadow share (or option) scheme.

Share schemes were once the flavour of choice for many companies – including early stage, high growth companies. Their key attraction was that employees could enjoy a tax-free uplift in the share's value if the company got the shares into the employee's hands at an early stage. This required the employee to pay market price for the share when joining the scheme, but this was once typically funded on a no risk basis by the company providing the employee with a limited recourse loan.

However, in recent years share schemes have fallen out of favour. Following changes to the tax regime in 2018, New Zealand's Inland Revenue Department (IRD) now assesses whether any tax is payable on the shares at the point at which the IRD determines that the employee actually economically owns (and has full risk and reward in) the shares. This means typical high growth company schemes are taxed like option schemes. The taxing point is pushed out until later when the employee gains full rights in the share – at this point, the employee must pay income tax at his or her personal rate on the difference between (1) the price he or she paid for the share and (2) the value of the share at the time the share is actually received.

Another disadvantage of share schemes is that they carry a high administrative burden, often requiring companies to establish and maintain a loan scheme and a trust to hold the employee's shares, and also as a result of the legal processes that must be followed if a participant leaves and the company wishes to buy back their shares. While this may not be problematic for companies establishing a scheme for a select group of individuals (such as a senior management team), it causes issues for early stage, high growth companies that establish a scheme for a large group of employees and can expect some staff turnover.

Option schemes have emerged as the scheme structure of choice as companies turned away from share schemes. Employees will be required to pay income tax at the time they exercise an option (which, as mentioned, is neutral with a typical growth company share scheme), but option schemes do not have the same administrative burden. In particular, it is very easy for companies to cancel an option if an employee leaves the company. Employees also take on no risk to participate in the scheme – they pay nothing to acquire their options and can choose whether or not to exercise their options after seeing how the company performs.

Phantom schemes – the logical next step?

Option schemes are not perfect, however. The key challenge is that once an option is exercised, the employee becomes a shareholder. This can result in the company having numerous employees on its share register (which is painful if the company needs to pass a shareholders' resolution, and can also raise Takeovers Code issues). The shares can be held in trust for the employees – but this requires the company to establish and administer a trust. Upon exercising their options and becoming a shareholder, the employees will also gain shareholder rights, including the right to information about the company.

One solution employed by some early stage, high-growth companies is to have a long window for employees to exercise their options (up to ten years), in the hopes that employees will delay exercise until a liquidity event (such as an IPO or sale of the company) is on the cards. Some have gone a step further, and provided that the options are not exercisable until a liquidity event occurs. This solves the issue of employees becoming shareholders – but it also means that employees are unable to elect to exercise their options early and enjoy any subsequent increase in the company's shares tax-free.

Where options will not be exercisable until a liquidity event occurs, the logical next question is whether the company's objectives for the scheme can be equally well or better met by a phantom share or phantom option scheme.

Phantom schemes – how they work

Under a phantom scheme, the employee receives a notional "unit' that entitles the employee to a cash bonus that is calculated by reference to the value of the company's shares. The bonus can either mimic a share (where the bonus paid is equivalent to the full value of the share) or an option (where the bonus amount is calculated by deducting a notional exercise price from the value of the share).

In New Zealand, the employee will pay income tax on the bonus when it is paid, which means that a phantom scheme is broadly tax neutral compared with an option scheme where the options are exercisable on a liquidity event.

Phantom schemes are very flexible. They can provide for a bonus to become payable upon a liquidity event occurring (which will be the focus for early-stage, high growth companies), but more established companies might also choose to pay a bonus equivalent to any dividend paid on the shares. Time-based vesting provisions and performance hurdles may also be imposed as desired.

A phantom scheme will not result in the company having numerous employees on the share register. A further advantage is that the company need not worry about compliance with securities law as no security is issued under the scheme – this makes phantom schemes comparatively simple to implement and administer. This is a particular advantage if the scheme is to be implemented overseas as well as in New Zealand as the company should not need to worry about securities law in multiple jurisdictions (although it is always important to get local legal advice).

Phantom schemes are also easy to explain to employees, and more importantly, easy to sell. The employee takes on no risk to participate in the scheme, and it is easy to explain to them that their bonus will be calculated as if they held an option or a share.

Phantom schemes – further considerations

There are a few points to be aware of with phantom schemes.

Most importantly, companies should be aware of the dilutive effect of granting a unit and should ensure that their shareholders support the implementation of the phantom scheme (as the creation of the scheme and issue of units will reduce the return to shareholders).

Companies should also bear in mind that the assessment of the benefits of a phantom scheme over an option scheme may differ for different jurisdictions – in particular, for jurisdictions where a capital gains tax is payable, it may be preferable for employees to pay tax upon exercising an option at the capital gains tax rate, rather than paying income tax on a bonus under a phantom scheme.

Finally, it is worth noting that IFRS 2 (Share-Based Payment), which applies to share and option schemes, also has specific financial reporting requirements for phantom schemes. This is a factor to take into account when assessing which employee equity scheme structure will work best for a company. The terms of a wellldesigned phantom scheme will also cover off compliance issues such as holiday pay and Kiwisaver, regulation of financial derivatives and the solvency test in the Companies Act 1993.

Conclusion

We are currently seeing a trend towards phantom schemes as companies recognise the advantages of a phantom scheme's flexibility and easiness to implement and administer. Any company considering establishing an employee equity scheme should seriously consider whether a phantom scheme will deliver on the company's objectives. Feel free to reach out to our team if you have any questions.

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