

How Phantom Stock Plans Turn Executives into Shareholders

And What Closely Held Companies Can Do Now to Improve Talent and Profits

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The majority of small to mid-size businesses face a serious challenge to attract and retain key employees, those who can make a difference in their companies. Larger, publicly-traded competitors can attract the best and brightest with stock options, restricted shares or other forms of equity compensation vehicles. *How, then, can smaller counterparts fairly compensate and motivate essential employees without granting them equity?*

Consider this worthwhile solution: The issuance of “phantom” stock. This compensation tool is designed to motivate and retain key employees without sharing company ownership. Such plans have the potential to yield payoffs similar to equity grants or stock options. By building phantom stock into your benefits strategy, you can pass on the same financial reward to consistently valuable executives or employees without incurring any of the risks or complications typically associated with equity sharing.

How Phantom Stock Works

The application of phantom stock is simple and straightforward. You grant your executive 1,000 shares of so-called phantom stock at \$10 a share, for instance. The phantom stock is not actual equity, but it is tied to the value of your company’s stock. You schedule a company valuation for some future date—or define a formula that illustrates a rise in your company’s stock by \$30 a share, for instance. And, you issue the executive a \$30,000 check. At tax time, your company qualifies for a \$30,000 tax deduction, while your executive pays taxes on \$30,000 worth of ordinary income.

Many forward-thinking companies will establish a formula that actually provides some retirement benefits to the “executive stockholder.” This action strengthens executive retention and further enforces a non-compete provision that extends beyond employment years.

By example, the company could set up a 10-year plan with the employee in position to earn “stock” equal to 1 percent of the company’s assessed value. At the end of that time, the employee could cash out over a 10-year period, and collect not more than 10 percent of his or her accumulated value each year.

Although many variations exist, the typical phantom stock plan creates deferred compensation units and tax deferral advantages. These elements are assigned a base value, which is equivalent to the value of a company’s common stock. An administrative committee then awards these compensation units to key employees. However, the plan usually places a limit on the total number of units that may be outstanding at any one time, as well as the number of units that may be awarded to any one employee.

A phantom stock plan provides advantages to both the employer-sponsor and the executive-participant. It can transform executives into shareholders with a strong personal motive to increase corporate profits. Ideally, the employer gains a competitive edge or “glue in the seat” to hold onto its best executives for a longer period of time. Many employers extend the process and stretch out payments for ten or fifteen years, as well as tie a non-compete to the payment schedule.

Real Valuation

Determining what your company is worth is essential when setting up phantom stock plans or other financial arrangements. In our experience, owners sincerely believe they know and understand their company’s value but, upon more thorough assessment, discover they are off the mark. In our opinion, it is a good business practice to retain an outside valuation firm for your appraisal.

Tax Treatment

From a tax standpoint, phantom stock plans are treated like nonqualified deferred compensation (DCP) arrangements. The plan must follow DCP requirements under IRC §409A, stating payout events upfront. Usually, payout benefits occur in installments over a period of time, commencing at retirement. The participant is not taxed until there is an actual receipt of benefit payments. Similarly, the company receives a deduction for the payment in the year the payment is actually made. There is no taxable income reported or deduction taken at the time contingent credits are made to a participant’s account.

Accounting Issues

From an accounting standpoint, the company must record a compensation charge on its income statement as the employee’s interest in the award increases. Thus, from the time the grant is made until the award is paid out, the company records the value of the shares, which are prorated over the term of the award. In each year, the value is adjusted to reflect the additional prorated share of the award the employee has earned, plus or minus any adjustments to the value arising from the rise or fall in the share price.

Unlike accounting for variable award stock options where a charge is amortized only over a vesting period—the charge builds up during the vesting period with phantom stock and SARs (stock appreciation rights). After vesting, all stock price increases are taken as they occur.

Plan Design

If you wish to consider the phantom stock plan, your first step is to determine the amount of stock to be awarded. Be cautious and avoid issuing too much stock to participants, and doing so too early. If you do, an unintended consequence may well be that stock is unavailable for future employees that have the potential to contribute mightily to your success.

The second step is to value corporate equity in a defensible and careful manner. Again, it is best to retain an outside firm that specializes in business valuations.

Your third step may give pause. Tax and regulatory requirements tend to cast a seemingly dangerous cloud over phantom stock. For example, the cash accumulated to pay for the benefit may be subject to an excess accumulation earnings tax (a tax applied to setting aside too much money in reserve versus using it for business needs).

If funds are set aside, one way to move out from under the regulatory clouds is to segregate these funds into a “Rabbi Trust” or “Executive Roth PlanSM.” This action enables employees to pay tax on the benefit when it is promised, not when it is paid. Additionally, take care when you select the participant group. Stay focused on a “select group of highly compensated and/or management employees” to avert ERISA concerns.

Plan Funding

A frequent issue in a phantom stock plan is how the employer informally funds its promise to pay plan benefits. The essential tension in nonqualified plan design lies between the need to maintain the plan as unfunded (so that benefits are not currently taxable and the plan is not subject to most of Title I of ERISA), but still secure executive benefits. The most common solution to this dilemma is a Rabbi Trust*. Although a Rabbi Trust is advantageous to the executive, the employer faces certain disadvantages (see Sidebar I).

The plan sponsor’s commitment to place investments in the trust, and earmark these investments to fund obligations under the plan, is the centerpiece of a Rabbi Trust. The most common assets used today to fund these obligations are life insurance and mutual funds.

Net Takeaway

Phantom stock is an excellent vehicle to incentivize your key executives to think and act as shareholders.

Key decisions to move toward a phantom stock plan are the careful determination of value (formula) for the stock and the amounts to issue. Fees invested in professional help will be well spent.

With the proper funding strategy in place, your customized phantom stock plan can help to facilitate future cash flow and, importantly, add meaningful value to the work life and retirement of select employees or executives.

After all, one of the major preoccupations of companies today is the tenuous quality of its talent pool. In the uncertain years ahead, companies will need to recruit and retain every talented executive possible.

[*The trust is so named because of the first favorable IRS letter ruling on which was issued to a Rabbi. The Rabbi Trust is an irrevocable trust used to fund deferred compensation benefits for key employees, providing certain protection on promised benefits.]

Sidebar I: Rabbi Trust

A trust created for the purpose of supporting the nonqualified benefit obligations of the employer to their employees.

These trusts are sometimes referred to as “grantor trusts,” which impacts how the assets in the trust are taxed. The asset is taxed at the grantor’s (employer’s) tax rate; therefore most companies use life insurance to shelter the assets from taxation in the trust.

Called a Rabbi Trust due to the first initial ruling made by the IRS on behalf of a synagogue, these forms of trusts create security for employees because the assets within the trust are typically outside the control of the employers and are irrevocable. The only downside to the employee is that those assets are subject to the employer’s creditors, which he or she will be one.