Phantom Stock

Clients, Business Owners, High Net Worth Individuals, Attorneys, Accountants and Trust Officers:

I hope you find this presentation informational and useful!

Thanks!

Mike
Phantom Stock

What is it?

Phantom stock arrangements are based on hypothetical investments in company stock. More specifically, phantom stock is the right to receive a cash or property bonus at a specified date in the future based upon the performance of phantom (rather than real) shares of a corporation’s common stock over a specified period of time. Typically, an employee is awarded a number of units of phantom stock each year (at the end of the year), based on his or her contribution to the company’s success.

**Example(s):** Anna is a long-time employee of XYZ Incorporated. She is an essential employee who knows the business and its customers. Anna is getting older and wants some lasting form of compensation in addition to her paycheck. XYZ Incorporated, however, has been a family-owned business for 35 years and its shareholders do not wish to issue stock to employees who are not family members.

**Example(s):** So, XYZ Incorporated decides to adopt a phantom stock plan. This plan gives Anna the right to receive cash at age 56, provided that she is still employed by the company. She’ll receive her bonus based on phantom stock plan units equal in value to one share of XYZ Incorporated stock. Units will be awarded at the end of each year according to Anna’s contribution to the company’s success. Both parties are happy with this arrangement.

How is the amount of the bonus calculated?

The amount of the bonus is often computed as the difference between the fair market value (FMV) of the stock at the date of grant and the FMV of the stock at the later specified date. Along with this appreciation in the value of the stock, the employee is also usually given an amount equal to the dividends paid over the same period of time.

**Example(s):** Michael, a key executive, enters into a phantom stock plan under which his employer awards him 10,000 phantom shares when the market value of each share is $50. The shares are credited with dividend equivalents. At the end of five years, Michael is paid an amount equal to the increase in the value of the shares over the $50 base amount, plus the dividend equivalents.

When can it be used?

**Corporation needs incentive to retain key employees**

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by giving phantom stock to particular employees.

**Current owners are unwilling to dilute their ownership**

Because the owners do not wish to dilute their ownership in the business, incentive stock options and other such methods should not be considered here. Instead, phantom stock can provide an incentive to the employee without the need for a stock issuance.

**Parties want compensation to be linked to company’s growth**

Phantom stock should be used when both the employee and the employer want compensation to be linked to the company’s growth.

Strengths

**Provides tax deferral for the employee**

The employee generally does not recognize federal income tax upon the grant of the phantom stock rights. Rather, he or she is generally taxed at ordinary income tax rates only upon the receipt of cash or stock at the settlement date.

**Provides tax deduction for the employer**
The corporation is allowed a deduction for compensation expense when the employee recognizes the income. Thus, the corporation deducts the amount of cash or market value of stock paid to the employee on the settlement date.

**Helps business to attract, motivate, and retain key employees**

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by giving phantom stock to particular employees.

Phantom stock is one example of golden handcuffs. In general, golden handcuffs refers to the combination of rewards and penalties given to key employees that compensates them so generously for staying with the company (and penalizes them so severely for leaving) that it would be unwise for them to leave the company. Phantom stock can serve as golden handcuffs if you establish a vesting period or holding period for the shares of stock—if the employee leaves the company before the requisite number of years has expired, he or she must forfeit the value of the shares.

**Avoids cumbersome Employee Retirement Income Security Act (ERISA) requirements**

Many employers offer qualified retirement plans to employees. Generally, such plans are subject to cumbersome ERISA rules pertaining to funding, vesting, disclosure, and other areas. Nonqualified plans are generally not subject to most ERISA provisions. By selecting a nonqualified plan, such as phantom stock, you can sidestep the cumbersome aspects of ERISA.

Therefore, from the employer's standpoint, it is wise to structure stock plans in a way that reserves to the employer the greatest degree of discretion with respect to the selection of participants, the size of awards, and the ability to terminate and reduce plan benefits. For practical purposes, this means that employers frequently offer phantom stock plans only to executives or other key employees—not to rank-and-file employees.

**Keeps ownership of business from being diluted**

The owners of small or family-owned corporations often fear giving stock ownership to outsiders. With phantom stock plans, the corporation's actual stock does not have to be given away. Thus, control of the business is not diluted.

**Minimizes the use of corporate funds for payment of compensation**

Cash flow is better than it would be with a typical deferred compensation plan, since the business does not need to pay out cash periodically to provide employees with deferred compensation.

**Tradeoffs**

**Corporation's deduction is deferred**

With qualified plans, corporations are generally entitled to immediate tax deductions for money contributed to employee plans. Phantom stock plans are nonqualified. As a result, the corporation's deduction is deferred— it gets a deduction on the settlement date.

**Phantom stock does not provide all of the rights associated with stock ownership**

From the employee's perspective, phantom stock does not provide all of the rights associated with stock ownership. In particular, voting rights are not provided. Thus, phantom stock may be less attractive to those employees who want more of an equity-based incentive.

**How to do it**

**Consult an attorney to set up the plan**

It will be necessary for you to consult an employee benefits/Employee Retirement Income Security Act (ERISA) attorney to set up your phantom stock plan. An attorney will consider the goals of your business and your financial situation and advise you of the most advantageous compensation plan to adopt. Additionally, it may be necessary to consult a certified public accountant to discuss funding arrangements for the plan and to ensure that proper accounting methods are followed.
Fund the plan

There are a number of options for funding a phantom stock plan, including the purchase of corporate-owned life insurance.

Tax considerations

To the employee

The employee generally does not recognize federal income tax upon the grant of the phantom stock rights. Rather, he or she is generally taxed at ordinary income tax rates at the settlement date (some time in the future).

To the employer

The corporation is entitled to an income tax deduction at the settlement date; that is, at the time when the employee includes the money in gross income.

Caution: IRC Section 409A contains complex rules that govern nonqualified deferred compensation (NQDC) plan deferral elections, distributions, funding, and reporting. If a NQDC plan fails to satisfy Section 409A’s requirements, participants may be subject to current income tax, as well as an interest charge and 20 percent penalty tax. Depending on its design, a phantom stock plan may be subject to section 409A’s requirements.
ABOUT MIKE FOLEY

Mike specializes in Business Owner Benefits, Buy-Sell Agreement Funding, Business Continuation, Estate Planning, Key Person Benefits, Executive Benefits, and Deferred Compensation Plans for Business Owners, Key Employees and High Net Worth Individuals.

Mike is an Independent Insurance Broker with over 27 years of experience representing over 100+ top insurance and financial services companies in the industry. This allows him to provide you the best product solutions based on your individual needs and circumstances. References available upon request.

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