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Phantom Stock to Reward (and Retain) Key Personnel

One challenge for the business owner is attracting and retaining key personnel. This challenge permeates all businesses from the largest to the smallest. At some point, the key person needs more incentive to stay and excel. One common tool to incentivize the employee to stay is to offer the employee stock. However, true stock incentive payments or options have some notable drawbacks discussed below.

Enter Phantom Stock. It's the coolest sounding arrangement that gives the employee some of the benefits of stock ownership without the drawbacks associated with real equity interest. It is also known by the less exciting name: the "stock equivalency plan."

When a company uses regular equity stock to incentivize employees, it usually does so through direct stock compensation or through stock options. Stock compensation (stock in exchange for work performed or as a bonus) is deductible by the company but taxable to the recipient. This can present a significant deterrent to the employee – the potential for no additional immediate income combined with the immediate tax bill. Further, depending on the type of entity, the employee may also need to pay tax on the company income without ever receiving any of the proceeds (so-called "phantom income"). The "stock option plan" (also known as the Incentive Stock Option or Qualified Stock Option) is where the employer allows the employee to purchase stock at a value that is the current fair market value, but it remains locked in for later purchase. The hope is that the stock appreciates and the employee then gets to purchase at the discounted locked-in price previously established. The granting of this option is generally not taxable but the tax is assessed when the employee sells the stock for which he previously exercised the option to purchase. At exercise, the employee needs cash to buy in to own the stock. Importantly, with the stock option, the company gets no tax deduction for the stock options offered.

In both the above options, the employee also becomes the shareholder. As a shareholder, the employee has not only the rights defined in the bylaws or articles, but also a whole host of rights offered by state law.

Phantom Stock is different. It is not real stock ownership. Instead it is simply the contractual relationship between employer and employee that gives the employee stock-like rights when it comes to income and even to the proceeds upon the potential sale of the business without incurring income tax to the employee upon receipt of the Phantom Stock. Also, Phantom Stock doesn't provide the employee with stock ownership rights.

Here's how it works. ABC Company has a key employee, John Smith. To retain John, ABC knows it has to offer John something more than the steady paycheck. John wants ownership so that his efforts result in not only the growth of the company but also the growth of his bank account. Instead of giving John 100 shares of the company's 1000 outstanding shares (10%), the company could give John the contractual right to the income associated with 100 pretend (or Phantom) shares of company stock. The company could also assign in the contract a base value for the shares (i.e. $5.00 per share) and any increase in share price could be additional value for John. As the value of the company increases, the value of John's shares could likewise increase.

One negative for John is that, because he doesn't own stock, he would not be entitled to capital gains treatment. But, unlike the bonus stock and the stock option, John need not put out any money (in the form of tax payments or payments for the stock) before receiving the phantom stock. Also, the potential for phantom income is eliminated.

John gets the profits that he wants but he doesn't get voting rights. This is good for the company. Is it bad for John? Probably not. At 10% ownership, even if he had real stock ownership, he is not likely able to make a meaningful contribution to the direction of most small businesses. He is a minority owner. Is the fact that John doesn't have voting rights a good thing for the company? It can be because the Company need not include John in annual meetings or seek out his vote. For many small businesses (especially those that are closely-held family businesses) this can be an important consideration for keeping the *busines*s of the family business in the *family*.

Phantom Stock is not right for everyone. Sometimes the Phantom Stock is not sufficient for the key employee. But if offering Phantom Stock can help you recruit and retain vital personnel to your business, talk to your planning professional to see if this arrangement can work for your business.

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