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PHANTOM STOCK PLANS

Incentivizing Key Employees with Golden Handcuffs

A phantom stock plan is an employee benefit plan that can help retain key employees by giving them a financial incentive to help grow the company. As the name implies, this type of plan involves giving select employees "phantom" or "mock" shares of company stock. Key employees can enjoy the benefits of stock ownership and be motivated to see the company prosper - all without diluting shareholder equity.

Phantom Stock Plan Basics

- ☐ Employer creates a benefit plan where a specified number of phantom shares are given to one or more key employees.
- ☐ The value of a phantom share is usually tied to the company's common stock and can be equal to the full value of a share of common stock (including dividends) or be based on the value of any increase in the company stock price over a certain period of time.
- ☐ The plan agreement should detail the initial value of the phantom shares, any vesting schedules, and when employees can cash in shares.
- ☐ Phantom stock plans are considered deferred compensation plans and must conform to IRS regulations. If designed and administered properly, an award of phantom shares should be non-taxable until cash is paid to the employee. Any amount paid is considered ordinary income to the employee and can be a deduction for the employer.
- ☐ One of the great advantages of phantom stock is flexibility. Plans can provide different benefits for different employees, including vesting rules, eligibility, rights to interim distributions of earnings, and methods of calculating payments due under the plan.
- ☐ In addition, the employer does not have to provide accountings or financial statements to the employee.
- ☐ A phantom stock plan can also be offered in exchange for a non-compete agreement that prevents the key employee from leaving for a competitor.
- ☐ Although the business should be valued annually, the plan does not need to be funded and the employer only needs to have cash on hand when payments come due.

Example

- ☐ ABC Company, Inc. ("ABC") is a small medical supply company in Florida. John is ABC's sales leader. ABC's owners would like to reward John and give him reason to stay with the company long term but are unwilling to give up any equity in the business.
- ☐ After weighing several options, ABC's owners decide to reward John with 10,000 phantom shares of company stock vesting after 5 years in exchange for a non-compete agreement.
- ☐ The value of 10,000 shares of common stock at the time of the award was $1,000,000. If at the end of the five-year vesting period those shares are worth $2,000,000, John would receive a cash payment equal to the $1,000,000 growth.
- ☐ The plan incentives John to stay with ABC and make the company more valuable.
- ☐ ABC's owners have not diluted their ownership in the company and have made ABC more attractive to a buyer since John is both incentivized to stay and restricted by the non-compete agreement.