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Employee Benefit Plan Review

Phantom Stock Plans: Are They Really That Spooky?

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Phantom stock plans can be a valuable method for companies to provide their key employees with meaningful incentive compensation without awarding actual shares of company stock. Usually, the award is for a specific number of units, or phantom shares, which track the price of the company's actual shares.

In a corporation, these arrangements are known as phantom stock or stock appreciation rights plans.

In a limited liability company (LLC) or partnership, these arrangements are called phantom units or equity appreciation rights plans.

In either case, the value of phantom stock will rise or fall in tandem with the company's actual stock (or the value of the company, if it is not a publicly traded company). The eventual goal is that employees are paid out profits at the end of a pre-determined length of time or specified event. These plans are especially effective in compensating the company's management team or a group of key employees.

The answers to the following frequently asked questions highlight the advantages of phantom stock plans and, hopefully, make these benefits less frightening when included as part of a total rewards program.

What Is A Phantom Stock Plan?

A phantom stock plan is a form of long-term incentive plan (LTIP) typically used by privately held businesses. Phantom stock is simply a promise to pay a bonus in the form of the equivalent of either the value of the company's shares or the increase in its value over time. A phantom stock plan is a deferred compensation arrangement that awards the employee a unit measured by the value of a share of a company's common stock, or, in the case of a limited liability company, by the value of an LLC unit. Also known as ghost shares, simulated stock, shadow stock, or synthetic stock, these phantom plans allow key employees to share in the company's growth without owning actual company shares.

The phantom share program allows a business to reward and incentivize key employees to align performance with company goals, support long term growth, and retain talent. However, unlike actual stock, the phantom stock award does not confer equity ownership in the company.

In other words, no actual stock is awarded to the employee under a phantom stock plan. Instead, the employee is granted a number of phantom stock units, and the plan provides that each phantom stock unit is equal in value to one share of common stock.

There are two types of phantom stock: Appreciation only, and full value.

Appreciation Only

Employees that receive appreciation-only phantom stock will receive the value above and beyond what the phantom stock was worth at the time of grant. This type of phantom stock is also commonly referred to as a stock appreciation right (SARs).

Full Value

Employees that receive full value phantom stock will be paid out exactly what the stock is worth in full value.

Why Is Phantom Equity More Preferable Than Actual Equity For A Company?

Phantom equity is often a better choice than providing actual equity because:

- Privately held businesses typically prefer to minimize the number of shareholders with actual equity to avoid additional voting rights or unforeseen minority rights.
- Executive employees can be awarded shares tied to subsidiary level value rather than the parent level value.
- Actual stock awards may require shareholder's agreements and other documents to be amended and increase company costs.

When Should A Company Offer A Phantom Stock Program?

- Ideally, when the company is anticipating future growth and the phantom stock plan will incentivize key employees to participate in that growth.
- The company is willing to share the growth with its key employees.
- The targeted growth needs to be substantial enough (typically, 5 to 15 percent) to retain key employees and provide sufficient incentives.

When Should A Company Not Offer A Phantom Stock Program?

- If the company intends to issue phantom equity to a large group of employees. Phantom stock must be provided to only a select group of key employees to avoid the constraints of the Employee Retirement Income and Security Act (ERISA).
- If the company only wants to make payments when employees terminate employment or retire. These types of qualified retirement plans must comply with ERISA regulations. For the intended tax benefits, a phantom equity plan is not designed to be ERISA compliant.
- When the company does not have sufficient cash to pay benefits when they are due.

How Does A Phantom Stock Plan Work?

Phantom stock works by tracking the increases and decreases in the value of the company's actual stock. Employees are compensated with profits from the stock appreciation after certain conditions are satisfied (i.e., vesting). The employees are usually paid in cash but could be paid in shares. For example, the company could grant the employee a 5% interest initially and increase the interest to 10% after the employee completes five years of service. Whether granted up front or over a period of years, the phantom stock units may either be immediately vested or subject to a vesting schedule determined by the company.

Phantom stock is usually based on a cliff or graded vesting schedule and vests (i.e., becomes available) in the following situations:

- Upon achievement of performance goals;
- Time-based vesting;
- Retirement;
- Voluntary termination; and
- Upon a change in control of ownership.

In certain situations, the employee may forfeit their entitlement to receive future payments (e.g., breach of non-compete restrictions or if terminated for cause).

How Is The Value Of A Phantom Stock Unit Determined?

As noted above, the value of a phantom stock unit is either measured by the value of a full share of company stock or, it is based on the stock appreciation over a period of time. The value should be specified in the phantom equity plan or grant award and determined by either a predetermined formula or a third-party appraisal.

The value of phantom stock units tends to fluctuate from year to year as the value of the company changes. Third party appraisals typically occur after certain events such as:

- A separation from service;
- A change in control; or
- A specified future date or fixed payment schedule.

In most cases, a valuation is required upon the employee's termination, death, or disability. In certain cases, a valuation may be required periodically, such as annually, or on a specific future date.

When Is Payment Of The Value In The Phantom Stock Made To The Executive?

The grant award will specify the number of phantom stock units, vesting schedule, form of payment (i.e., lump sum or installments over a period of years), and triggering payment events. Actual payments may be made on a date certain or when the employment relationship is terminated due to retirement, death, or disability.

The phantom stock plan must specify when the payments should begin. If payments are to be made in installments, the phantom stock unit plan or grant agreement should also specify whether interest will accrue on the unpaid installments.

What Are The Tax Implications Of Phantom Stock?

Phantom stock plans are deferred compensation plans and must be designed and drafted to conform to the requirements of Section 409A of the Internal Revenue Code (Code).

Tax Implications for Employees

For income tax purposes, if the phantom equity plan is compliant with Code Section 409A, then when shares of phantom stock are granted, there is no tax impact on the employee. Instead, when the payment is received in cash, it will be taxed as ordinary income (not capital gains) to the employee. The payment is also subject to Federal Insurance Contributions Act (FICA) taxes (i.e., Social Security and Medicare taxes) when the benefits vest (i.e., become available). This is different when compared to actual stock for which the increase in value on a disposition may be eligible for favorable capital gains tax rates.

For FICA purposes, these deferred compensation payments are includible as wages in the later of either the year in which the related services are performed, or the year in which the deferred compensation becomes vested. As the phantom stock units become vested over time, the value of the phantom stock units is includible as wages subject to FICA taxes. This is the case even though the amounts are not subject to income tax until actually paid to the employee.

Note also that if the phantom stock plan provides that payment is settled in shares rather than cash, the amount of the gain is taxable at exercise. Any subsequent gain on the shares is taxable as capital gains at the time of sale.

Tax Implications for Employers

At the time the payment becomes taxable to the employee, the company is entitled to a deduction in a corresponding amount (subject to general limitations under Code Section 162 with respect to the amount being reasonable and not excessive). The company is also subject to FICA taxes at the time the benefits vest (i.e., become available).

For these favorable tax results to apply, companies should ensure that the terms of the phantom stock plan are in compliance with Code Section 409A prior to the phantom equity plan becoming effective. A violation of the Code Section 409A rules could cause immediate taxation, plus an additional 20% tax, as well as the assessment of penalties all prior to any actual receipt by the employee. For any payments that are made after the employee terminates service, the payment is still treated as compensation for tax purposes and reported on Form W-2.

For financial reporting purposes, the company records the compensation expense on its income statement as the employee's interest in the award increases. In the year of grant, the company expenses the value of the award received, even though the award may be subject to vesting restrictions. In each year, the value and expense are adjusted to reflect the additional pro-rata share of the award the employee has earned, plus or minus any adjustments to value arising from the rise of fall in share prices. Accounting treatment becomes more complicated if vesting occurs gradually over time or based upon performance, or if the award is settled in company shares.

Conclusion

Phantom stock plans can provide valuable incentives to the employees receiving them and the employer providing them by generating increased engagement and improved company performance. For this reason, companies should not be frightened when considering whether phantom stock plans should be included as part of their overall benefits program.

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