Phantom stock

How to incentivize key employees

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Key employees all want to own a piece of the action. If the company is phenomenally successful, they want to share in the riches. There are several ways to incentivize key employees over both the short-term and the long-term — stock options, restricted stock, non-voting stock and phantom stock are common methods. Of these options, phantom stock is the best choice for the small business owner.

"Phantom stock provides the key benefits of stock ownership without any of the liability or hassle," says Peter J. Smith, a member at Semanoff Ormsby Greenberg & Torchia, LLC.

Phantom stock is essentially a cash bonus that is deferred until some triggering event in the future. Typically much larger than an annual bonus, the award is usually contingent upon the phantom stockholder's continued employment with the company. This aids with retention of key management personnel.

Smart Business spoke with Smith about phantom stock, how it works and how to implement a phantom stock plan.

How does phantom stock work?

Phantom stock is very simple. It is essentially a contract with the employee whereby the employee earns fictional equity rights. It can include both a share in the appreciated value of the business and a share of profits or annual dividend equivalents.

What does a company need to do to implement phantom stock?

A company needs to adopt a plan and issue 'grants' to employees based on the terms the business owner desires. The plans are flexible. They can include vesting over time, forfeiture for cause provisions, limited triggering events or a payout over time upon an employee's death, disability or retirement.

How can phantom stock aid with the retention of key management personnel?

Employees today want to feel that they have a vested interest in the upside of the business and that they're not just killing themselves to make money for their boss or owner. If you want employees to stay with you and be vested in the long-term growth of your company, a good strategy is to give them a piece of short-term profit and long-term growth. The phantom stock should be set up so the longer they stay the bigger their piece gets.

What are some of the issues associated with employees owning real stock?

There are tax issues as the employees will receive Schedule K-1 tax forms with income allocated to them, but the business owner may not want to make distributions to shareholders to cover the tax liability. Banks may ask that they participate in loans. Shareholders' agreements will be required to protect the business owner, and administering some stock plans can be complicated.

As shareholders, employees are entitled to detailed financial and other information, and have various rights under business corporation laws. For the entrepreneur or family business, sharing information about profits, expenses, owner compensation or employee compensation with employees may not be desirable. The employees might not be happy to learn that profits could be higher but for the owner's personal expenses. Owners have to be willing to share information and be open about how they're operating the business.

How are phantom stock plans taxed?

There are no tax ramifications at the time of grant, so there is no bookkeeping or administration required. Upon a triggering event, money is paid to the employee in accordance with the grant and is taxed as income to the employee, while the company gets a deduction. This is different than stock and more beneficial to the company.

How is the company valued for the purposes of a phantom stock plan?

There are multiple valuation methods a company can choose, but once one is chosen it must be used consistently. An employee can receive a share of the company value at the time of the grant or only the appreciation in value with a baseline set in the grant. This incentivizes the employee to help grow the company.

Is phantom stock only available to corporations?

No. There are many plans for LLCs, as well. They are called phantom interest plans or phantom unit plans. ●