How Do Phantom Stock Plans Work?

In the world of executive compensation, there are a number of ways that a company can reward key employees. Although most companies are familiar with traditional deferred compensation plans, one of the lesser known options which is growing in popularity is called a “phantom stock plan”. Especially in small to mid-size companies.

Here is the most common situation, a closely held business or family business has a key employee that they would like to reward but also further tie that employee to the company. The current owners of the company do not want to give up equity but they want to tie this reward system to the actual performance of the company as if that key employee was an owner or shareholder. This can be accomplished via a phantom stock plan.

These plans provide select employees with additional compensation equal to the appreciation of a percent of the company for a partnership, LLC, or PLLC, or in the case of an S-corp or C-corp a given number of shares in the company even though the ownership only exists in theory. For example, I own a company that is incorporated as a partnership and I would like to reward a key employee by providing them with an annual cash reward equal to a 5% ownership stake in the company without formally making them a partner. Once the books are closed at the end of year I will issue a cash bonus to that employee equal to 5% of the net profits for the year. From the employee’s standpoint, they are receiving the monetary reward mimicking a 5% ownership share of the company so they have an incentive to continue to grow the company. From the employer’s standpoint, they have taken further steps to retain a key employee, they can deduct the additional comp pay to the employee, and the current owners have retained full control of the company.

The features of these plans and how they are design are limitless because they are just another flavor of nonqualified executive compensation plan. A few plan design features are listed below:

- Companies have full discretion as to who is covered and not covered by the plan
• Instead of paying out the benefit each year as compensation, the company can attach a vesting schedule to essentially put “golden handcuffs” on the key employee. If they leave the company prior to a stated date they lose the benefit.

• When awarding the shares or ownership the company can limit the award to just the appreciation of their shares or ownership percentage and not award the full current value of the ownership percentage. These are called “appreciation only” plans. Appreciation only phantom stock plans can be viewed as a favorable option to key employees because it does not require them to make a cash outlay to purchase their ownership interest as would normally be required by an actual equity or share purchase.

How do these plans work from an operation standpoint? The ownership percentage or shares are issued to the employee as hypothetical units or “phantom units” that are just tracked internally by the company. The employee is taxed on the benefit and the company can take the deduction for the compensation paid when there is no longer a “risk of forfeiture”. In other words, when the employee vests in the benefit whether they decide to “sell their phantom shares” or not. As soon as the employee has the ability to “sell” their phantom interest in exchange for compensation that triggers the taxable event.

When designed correctly, these plans can be a valuable tool for small to mid-size companies in their efforts to retain key employees.

About Greenbush Financial Group
Greenbush Financial Group, LLC is an independent registered investment advisory firm located near Albany, NY. The firm offers employer sponsored retirement plans, fee based financial planning, and investment management services.

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