Phantom Stock Plan

A powerful and highly flexible tool used to keep your executive team happy.

This article is reprinted from California CEO, November 2002, Volume 2, Number 10, page 22. Copyright © 2002 by California CEO Inc. All Rights Reserved.
This PDF edition is reproduced by permission. Unauthorized reproduction is prohibited unless expressly permitted by California CEO Inc.

FINANCIAL PLANNING

BY STEPHEN E. FOX

If you're like many other CEOs, you know you needed special help from your key people to survive the recent slowdown in the economy. You also should know that, having honed their skills in tough times, those same people now may prove attractive commodities on the job market, and you could lose them.

Don't let it happen. Just as you needed good people in hard times, you'll need them in good times, too. So, you have to be aware that some of your key executives are keeping their options open and you have to plan ahead to keep them happy.

One way you can achieve this is with a phantom stock plan designed to reward executives for work that will take your company onto the next, more prosperous level.

Phantom stock plans are nonqualified deferred compensation plans — nonqualified in the sense that they don't qualify for the special tax advantages given pension or 401(k) plans. On the upside, they allow you to give special treatment to only special people, and since they involve phantom, not real stock, they don't dilute ownership or entangle you with minority shareholders. They also don't expose your key people to the ugly tax surprises possible with traditional stock option plans, as happened to uncounted numbers of "new economy" executives in the 1990s.

Instead they give your key people a means to create wealth for themselves to the extent that they increase your own.

Assume that you own a business worth $10 million and that, with help from four key people, you think you can drive growth by 15 percent a year, doubling the value of your company in five years. You decide you're willing to share 20 percent of that growth with your key people, or $2 million, divided equally. That means $500,000 each — a healthy pop for your 35-year-old sales manager, who will have children heading for college in five years, and for your 55-year-old CFO, who soon will be thinking of retirement.

Benefits and consequences

Before you put a phantom stock plan into action, you first should determine what you need from each of your key people to reach your overall goal and then work backward to set annual goals specific to the individual. Say you want your sales manager to increase sales by 12 percent per year, and you want your CFO to cut your cost of capital from 12 percent to 8 percent and to reduce the aging of your accounts receivable from 55 to 40 days.

Put in writing, your plan gives each individual the chance to earn 1,000 shares of phantom stock, or units, over five years, each carrying a value based on a formula approximating the value of your common stock — $250 per unit right now and, you hope, $500 in five years.

> **Reward executives for work that will take your company onto the next, more prosperous level.**

You tell your sales manager that she will earn 200 units for each year she increases sales by 15 percent. If she hits 12 percent, she earns only 150 units for the year, and if she hits 10 percent, only 100 units. Similarly, you tell your CFO he will earn 100 units for each year he keeps your cost of capital under 8 percent and another 100 units if he cuts your accounts receivable to 40 days, with fewer units earned for lesser performance. You devise similar formulae for the other key people on your team.

Note that these goals reflect what each executive must do to help you double the value of your company over five years. Also keep in mind that they identify the tactics by which you play the game for five years and that they give everybody clear yardsticks by which to measure performance.

Last but not least, remember that the plan binds you to pay your key people as much as $2 million five years down the road, depending on the number and value of the units they earn in the meantime. You must provide for this obligation, if only to show that you take the plan just as seriously as you want your key people to.

To that end, you might establish a sinking fund into which you deposit CDs or you might buy low-load, high-cash-value life insurance to take advantage of the tax-deferred buildup. Another possibility is to plan for a liquidity event such as a sale, perhaps even to your executives, using cash generated by the phantom stock payout.

The tax and accounting consequences of phantom stock plans are fairly simple:

- You can deduct money used to fund such a plan — for example, sinking-fund money — only when actually paid to your executives, and you can't shield it from your creditors.
- Your executives incur no tax obligation until they receive the cash, upon which they pay income taxes at ordinary, not capital gains, rates.
- Your accountant probably will treat the obligation accruing under the plan as a liability on your financial statements, offset by assets such as CDs or life insurance set aside to fund the plan.

These are general rules, but there are ways to finesse them. For example, plans can be structured to provide a current tax deduction for money set aside to fund such a plan and even to protect the assets from creditors. Don't let them dissuade you from giving serious consideration to the idea. Phantom stock plans give you a powerful and highly flexible tool with which to reward those on whom you rely to succeed — and to make sure that they stick around long enough to help you do so.

Stephen E. Fox is a member of SAK Financial, LLC in Encino. He can be reached at sfox@sakfinancial.biz.