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# Long-term Compensation Choices: Real Equity or Phantom Stock?

By Marc Stockwell

Shareholders, business owners, and Boards have two primary options when considering key employee long-term compensation linked to shareholder value. Long-term compensation is typically structured to:

- Motivate, reward and retain key employees
- Promote long term thinking
- Grow the business
- Build shareholder value

At the same time, talented and entrepreneurial employees are looking for opportunities to become owners, to share in the success and create wealth for themselves and their families. So what's the right way to deliver the long-term compensation aligned with shareholder value? Sharing real equity or using phantom stock?

Like many other business decisions, the choice of real or phantom equity can be a challenging one. The answer depends on your philosophy, corporate governance and culture, objectives, corporate structure, and the desires of your key employees.

I believe that if using real equity is practicable, it serves as the best way to deliver long-term compensation. Key employees become shareholders and enjoy the same benefits as other shareholders. This may include voting rights, dividend rights and the opportunity for capital gains once the shares are earned and vested. This is the case for virtually all public companies which use their shares as the "currency" to deliver at least part, if not all, of the long-term compensation.

Real equity works for certain privately held businesses which hold a philosophy of key employee ownership and can manage the issues of having minority shareholders. Real equity is also used as part of a shareholder succession plan – replacing one generation of owners with the next.

However, in many cases, particularly with closely held businesses and not-for-profit organizations, the use of real equity is not possible or practicable. Examples include a family business that desires to keep stock ownership in the family or with a single business owner who doesn't want to deal with minority shareholders.

## Issues with Having Minority Shareholders

Many corporate attorneys will advise their clients against having minority owners because of the issues it presents. These issues include:

- Governance issues including minority shareholder rights to dissent against mergers and other significant corporate transactions.
- Minority shareholders of private companies may have unrealistic expectations regarding their role in corporate decision-making.
- Minority shareholders may have voting rights (if common shares carry voting privileges).
- Minority shareholders owning enough stock individually or collectively may create obstacles to corporate action and have the right to petition a court for the involuntary dissolution of the corporation. During times of great opportunity or immense hardship, minority shareholders can cause trouble.
- Minority shareholders may exercise inspection rights and force privately owned businesses to produce their accounting records.
- It may be difficult to terminate the employment of a minority shareholder.
- Minority shareholders may make claims of excessive compensation of majority owners or question expense reimbursements.

## Phantom Stock

This is a form of compensation where a company promises to pay cash at some future date, in an amount equal to the market or formula value of a number of shares of its stock. Thus, the payout will increase if the stock price rises, and decrease if the stock falls, but without the recipient actually receiving any stock. Like other forms of stock-based compensation plans, phantom stock broadly serves to encourage employee retention, and to align the interests of recipients and shareholders. Recipients are typically employees, but may also be directors, third-party vendors, or others.

In general terms, phantom stock is a compensation plan that confers the right to receive cash at a future point in time, typically tied to a valuation formula. Design of a phantom stock plan can replicate the value of real stock. The value of the company's stock or the appreciation in the value of the stock after the date of the phantom stock award determines the amount of compensation.

The award is usually contingent upon the phantom stockholder's continued employment with the company, i.e. retention of key management.

When a business is sold, the phantom stockholder might receive an amount equal to the cash the recipient would receive if he or she owned the same percentage of the corporation's stock (or the appreciation in value of an equivalent amount of stock). Some plans also include participation in dividends paid to shareholders.

Designed and administered properly, phantom stock should be non-taxable until the cash is paid, generating ordinary income for the employee and a deduction for the company.

Plans that are limited to only key employees should be free from the burdens of ERISA rules governing participation, vesting, funding and fiduciary responsibilities.

Implementing a phantom stock plan should cost less in legal and accounting fees than a formal stock program with buy-sell agreements.

Phantom stock provides a way to share a stake in a business while avoiding the need for the new "owner" to invest cash or suffer taxable income. Most importantly, phantom stock avoids the risks inherent in having additional shareholders.

Questions? Contact the Findley consultant you normally work with, or contact Marc Stockwell at *marc.stockwell@findley.com*, 419.327.4122.



| Highlights: Real Equity v. Phantom Stock | | |
|---|---|---|
| **Element** | **Real Equity** | **Phantom Stock** |
| Alignment | Very effective at aligning key employee interests with shareholders since employees become shareholders | Economically aligns interests of key employees with shareholders |
| Rewards | Dependent on stock price at time shares are sold – could be market price (if market for shares), valuation formula or appraisal | Dependent on valuation formula or appraisal at time phantom shares are paid |
| Voting Rights | May or may not provide voting rights – depends on type of stock used (voting or non-voting) | No voting rights |
| Dividend Rights | Common shares with dividend rights are typically used | No dividend rights are provided; however, dividend equivalent bonuses are often used to provide equitable results for phantom shareholders. |

| Element | Real Equity | Phantom Stock |
|---|---|---|
| Funding | Generally, no assets are set aside to fund redemption of real shares although effective cash planning for anticipated redemptions is advisable | Generally, no assets are set aside to fund payment of phantom shares although effective cash planning for anticipated payments is advisable; while not prevalent, may set aside funds, e.g., in a rabbi trust, to meet future payment requirements. |
| Tax Treatment | Unless purchased for fair value, shares transferred are taxable as ordinary income (wages) at fair value when vested; it is possible to pay taxes early if Section 83(b) election available; option gains are taxable upon exercise.<br><br>Once shares acquired and income recognized, future appreciation taxable as capital gains.<br><br>Company takes tax deduction equal to amount included in income of key employee. | Phantom shares are taxable as wages when paid. There is no opportunity for capital gains (all ordinary).<br><br>Company takes tax deduction equal to amount included in income of key employee<br><br>No taxable event until payment<br><br>No opportunity for capital gains (all ordinary) |
| Retention | Vesting schedules used to promote retention | Vesting schedules used to promote retention |