CLAYTON CAPITAL PARTNERS

Exit Planning NAVIGATOR

Exit Planning Strategies for the Entrepreneur

Issue 56

# Phantom Stock Plan: The Stock Plan That Isn't

Faithful and long-term readers of **The Exit Planning Navigator®** are familiar with incentive plans for key employees. In the first of two prior issues (Issue 48), we covered the "whats" and "whys" (the goals and the four basic elements of) successful incentive plans. The second in that series (Issue 49) discussed how to design performance criteria that give a successful incentive plan its punch.

As a quick refresher, we suggested that when an owner decides to financially motivate a key employee (or management in general), his question should be, "Can this employee increase the value of my business in a measurable way?"

If the employee in question is a sales manager and the answer yes, then the owner designs an incentive plan to motivate the sales manager to behave in a way that fosters an increase in business value. This may seem elemental, but it is not. Too often we see **stock** awarded to a sales manager when a **cash-based** plan directed at increasing sales is not only more effective, but also more appreciated.

Let's look at how one owner solved the problem of matching the incentive to his desired result.

*During an annual performance review, Tom Sugar's Chief Operating Officer expressed an interest in owning part of the company. Tom was really not interested in taking on a co-owner because he eventually wanted to transfer his company to his daughter. He didn't want to sell or bonus stock, but he didn't want to lose his key employee. Tom was at an impasse. His CPA had told him that it rarely made sense to mix ownership among family and employees. On the other hand, Tom's COO wanted the look, the feel, and financial rewards of stock ownership.*

*Tom wanted a way around this impasse. Tom's advisors suggested that, instead of ownership and instead of just a cash bonus, Tom created a Phantom Stock Plan.*

A Phantom Stock Plan meets both the needs of the key employee and of the owner, because it gives employees something that looks like stock, grows in value like stock, and can be turned in for cash just like stock, but is not stock.

As employees strive to make the company more valuable, they make their interest in the Phantom Stock Plan more valuable. Typically, phantom shares corresponding to shares of stock – but not representing actual ownership – are allocated to the participating employees' accounts. As the value of true stock increases, so does the value of the phantom stock. Any dividends paid on the stock are credited to the employee's account. When the employee terminates his employment, the company typically pays him the per share equivalent value of each of the phantom shares vested in his account. The amount paid is deductible to the company.

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## Phantom Stock Plan: The Stock Plan That Isn't
(continued)

The success of a Phantom Stock Plan depends on careful design of vesting, forfeiture, payment schedules and funding devices. The benefit formula used in Phantom Stock Plan is the value of the company’s stock.

Phantom Stock Plans also work well when the key employee does not want be an owner. This is a much more common situation than owners think. Most employees are employees because they want to be employees. They do not want the risk and stress of ownership. Phantom stock gives these employees the look, feel, and some of the financial rewards of ownership, without the attendant risk.

Another suitable situation for the Phantom Stock Plan is when the owner wants to reward a long-term employee who has contributed to the growth and value of the company. This is most appropriate when the employee is within ten years or so of retirement. In this case, it simply makes no financial or tax sense to sell stock to employees when, within a relatively short period of time they are going to turn around and sell it.

Phantom Stock Plans are popular incentives for all of the reasons discussed above. The next issue of **The Exit Planning Navigator®** examines yet another advantage—tax savings.

*Subsequent issues of* **The Exit Planning Navigator®** *discuss all aspects of Exit Planning.*

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