Phantom Stock and Stock Appreciation Rights (SARs)

For many companies, the route to employee ownership is through a formal employee ownership plan such as an ESOP, 401(k) plan, stock option, or employee stock purchase plan (ESPPs - a regulated stock purchase plan with specific tax benefits). But for others, these plans, because of cost, regulatory requirements, corporate considerations, or other issues will not be the best fit. Other companies may have one or more of these plans but want to supplement them for certain employees with another kind of plan. For these companies, phantom stock and stock appreciation rights may be very attractive.

There are a number of situations that might call for one or more of these plans:

- The company's owners want to share the economic value of equity, but not equity itself.
- The company cannot offer conventional kinds of ownership plans because of corporate restrictions, as would be the case, for instance, with a Limited Liability Corporation, partnership, a sole proprietorship, or an S corporation concerned about the 100-owner rule.
- The company already has a conventional ownership plan, such as an ESOP, but wants to provide additional equity incentives, perhaps without providing stock itself, to selected employees.
- The company's leadership has considered other plans but found their rules too restrictive or implementation costs too high.
- The company is a division of another company, but can create a measurement of its equity value and wants employees to have a share in that even though there is no actual stock.
- The company is not a company - it is a nonprofit or government entity that nonetheless can create some kind of measurement that mimics equity growth that it would like to use as a basis to create an employee bonus.

This article provides a brief overview of the design, implementation, accounting, valuation, tax, and legal issues for the four kinds of plans it covers. None of these plans should be set up without the detailed advice of qualified legal and financial counsel. Sharing equity is a major step that should be considered thoroughly and carefully.

Phantom Stock

Phantom stock is simply a promise to pay a bonus in the form of the equivalent of either the value of company shares or the increase in that value over a period of time. For instance, a company could promise Mary, its new employee, that it would pay her a bonus every five years equal to the increase in the equity value of the firm times some percentage of total payroll at that point. Or it could promise to pay her an amount equal to the value of a fixed number of shares set at the time the promise is made. Other equity or allocation formulas could be used as well. The taxation of the bonus would be much like any other cash bonus--it is taxed as ordinary income at the time it is received. Phantom stock plans are not tax-qualified, so they are not subject to the same rules as ESOPs and 401(k) plans, provided they

do not cover a broad group of employees. If they do, they could be subject to ERISA rules (see below). Unlike SARs, phantom stock may reflect dividends and stock splits. Phantom stock payments are usually made at a fixed, predetermined date.

Stock Appreciation Rights

A stock appreciation right (SAR) is much like phantom stock, except it provides the right to the monetary equivalent of the increase in the value of a specified number of shares over a specified period of time. As with phantom stock, this is normally paid out in cash, but it could be paid in shares. SARs often can be exercised any time after they vest. SARs are often granted in tandem with stock options (either ISOs or NSOs) to help finance the purchase of the options and/or pay tax if any is due upon exercise of the options; these SARs sometimes are called "tandem SARs."

One of the great advantages of these plans is their flexibility. But that flexibility is also their greatest challenge. Because they can be designed in so many ways, many decisions need to be made about such issues as who gets how much, vesting rules, liquidity concerns, restrictions on selling shares (when awards are settled in shares), eligibility, rights to interim distributions of earnings, and rights to participate in corporate governance (if any).

Tax Issues

For both phantom stock and SARs, employees are taxed when the right to the benefit is exercised. At that point, the value of the award, minus any consideration paid for it (there usually is none) is taxed as ordinary income and is deductible to the employee. If the award is settled in shares (as might occur with an SAR), the amount of the gain is taxable at exercise, even if the shares are not sold. Any subsequent gain on the shares is taxable as capital gain.

Accounting Issues

The company must record a compensation charge on its income statement as the employee's interest in the award increases. So from the time the grant is made until the award is paid out, the company records the value of the percentage of the promised shares or increase in the value of the shares, pro-rated over the term of the award. In each year, the value is adjusted to reflect the additional pro-rata share of the award the employee has earned, plus or minus any adjustments to value arising from the rise of fall in share price. Unlike accounting for variable award stock options, where a charge is amortized only over a vesting period, with phantom stock and SARs, the charge builds up during the vesting period, then after vesting all additional stock price increases are taken as they occur. when the vesting is triggered by a performance event, such as a profit target. In this case, the company must estimate the expected amount earned based on progress towards the target. The accounting treatment is more complicated if the vesting occurs gradually. Now each tranche of vested awards is treated as a separate award. Appreciation is allocated to each award pro-rata to time over which it is earned.

If SARs or phantom stock awards are settled in shares, however, their accounting is somewhat different. The company must use a formula to estimate the present value of the award at grant, making adjustments for expectd forfeitures.

ERISA Issues

If the plan is intended to benefit most or all employees in ways similar to qualified plans like ESOPs or 401(k) plans, and it defers some or all payment until after termination, it may be

considered a de facto "ERISA plan." ERISA (the Employee Retirement Income and Security Act of 1974) is the federal law that governs retirement plans. It does not allow non-qualified plans to operate like qualified plans, so the plan could be ruled illegal. Similarly, if there is an explicit or implied reduction in compensation to get the phantom stock, there could be securities issues involved, most likely anti-fraud disclosure requirements. Phantom stock plans designed just for a limited number of employees, or as a bonus for a broader group of employees that pays out annually based on a measure of equity, would most likely avoid these problems.

Planning Issues

The first issue is figuring out how much phantom stock to give out. Care must be taken to avoid giving out too much to early participants and not leaving enough for later employees. Second, the equity of the company must be valued in a defensible, careful way. Third, tax and regulatory problems may make phantom stock more dangerous than it seems. Cash accumulated to pay for the benefit may be subject to an excess accumulated earnings tax (a tax on putting too much money in reserve and not using it for business). If funds are set aside, they may need to be segregated into a "rabbi trust" or "secular trust" to help avoid causing employees to pay tax on the benefit when it is promised rather than paid. Finally, if the plan is intended to benefit more than key employees and defers some or all payment until after termination or retirement, it may be considered a de facto "ERISA plan." ERISA (the Employee Retirement Income and Security Act of 1974) is the federal law that governs retirement plans.