Phantom Stock Plans

A phantom stock plan is a type of incentive compensation plan which a company can use to reward management for increasing the value of the company. Although this type of plan often uses the changing value of the company as a basis for determining the amount of a bonus, the actual payment is made in cash.

The covered employees are offered an annual bonus based on a percentage of the increase in the company's value.

For example, the sole shareholder of ABC Company offers a senior executive a cash bonus equal to 20% of the increase in the company's value during a particular year. The company's value would need to be determined at the beginning of the year and again at the end of the year. Let's assume that the company's value increases by $1,000,000 during that year. The executive would be paid a cash bonus following the close of the year in the amount of $200,000 (20% of $1,000,000).

One key advantage of a phantom stock plan is that it aligns the goals of senior management with the goals of the shareholders. Both want to see the value of the company increase.

The shareholders may prefer this type of plan as an incentive for senior management when they do not want to dilute ownership of the company. Also, the executives may prefer receiving cash instead of stock for many reasons. For example, they desire liquidity and they want to avoid personal exposure to lawsuits filed against the business and other risks that come with business ownership.

For publicly-traded companies, determining the beginning and ending values is not a problem. But determining the value of a privately-held company may not be as easy as it sounds. An experienced business valuator could handle the task. However, other measures are sometimes used instead of company value. As an alternative, a plan could use a formula which takes into account net earnings for the year and/or changes in net book value. In these situations, the executive(s) would be paid a cash bonus determined as some percentage of net income and/or a percentage of the increase in net book value.

Employees who are not responsible for overall management of the company may be offered customized plans which are measured by the specific factors that they manage. As an example, the VP of Marketing may be offered a bonus based on a percentage of sales over a budgeted level.

These plans are not "qualified" plans and are therefore not subject to heavy regulation by the Internal Revenue Service or U.S. Department of Labor. This allows the company significant flexibility in designing an appropriate incentive for each participant. The plans can be selective in that certain members of the management team can be included without including all of the company's officers.

A phantom stock plan can be an effective incentive for senior management since it ties the goals of those key employees to the goals of the shareholders. The terms should be well thought out. As a form of golden handcuffs, include a requirement that the executive must still be employed by the company when payment is due in order for him/her to qualify for the bonus.

To make the plan work smoothly, the terms should be relatively simple and clear, and not based on measures that are subject to easy manipulation by the participating employees. However, the attorney drafting the plan must also be careful to comply with Internal Revenue Code section 409A, which is lengthy and complicated.

Please Note

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