Phantom Stock Plans

Recruiting, retaining and motivating key employees is a key-success factor for the majority of businesses today. Our experience at Fuller Landau is that all successful businesses plan for their future success.

The vast majority of our clients are mid-market privately-owned businesses engaged in a variety of businesses and industries. For most, in order for these businesses to survive and successfully grow in the future, they need to shift their operational orientation from a short-term reactive (survival) mentality to a proactive long-term professionally managed business model. Concurrent with the change in management systems, these privately-owned businesses will often require management skills, experience and objectivity of key employees to assist the company in its longer-term orientation.

Attracting, recruiting and retaining key employees over the long-term will require both stimulating and challenging job opportunities within a company as well as creative compensation programs which satisfy the entrepreneurial needs of the key employees.

Properly designed long-term incentive plans will help focus and motivate key employees on the longer-term business goals and objectives of a company. These plans can create an environment whereby the goals of the shareholder(s) and key employees are congruent and focused on improving business value. A great plan will allow the shareholders to view his/her management team as business partners rather than employees and may lead to attracting and retaining key employees for many years.

Case Study

A Fuller Landau client (referred to herein as “PrivateCo”) planned for significant growth over the next five years. To their credit, they recognized the need for a comprehensive dynamic strategic business plan to create a blueprint for long-term viability. One of the key components of the business plan was to retain their key people and specifically address the long-term needs of their executive management team (referred to herein as “EMT”) because the shareholders recognized that they were integral to the future success of the company.

The shareholders had the following concerns with respect to their five year business plan:

1. How to retain sufficient profits to enable/finance growth?
2. How to recruit and keep talented employees at the executive level?
3. How do you make your compensation/benefits plans attractive without jeopardizing the financial viability of your business?
4. How do you motivate employees to look beyond current years’ earnings – annual bonus and balance that view with building long-term value?
5. How do you fairly compensate key employees without significantly diluting shareholder ownership?
6. How do you defer larger bonus payments to employees until a significant event occurs (e.g. sale of the business)?
7. Generally, how to retain these key employees over a longer-term horizon?

In addition, the shareholders of PrivateCo identified the following goals in respect to a long-term incentive plan for key employees:

1. Design a plan to afford the EMT the opportunity to participate in the future value of the company upon a sale of the business.
2. Provide meaningful long-term wealth creation for the individual members of the EMT.
3. Maximize the value of the company with optimized management focus and effort.
4. Be very lucrative to the individuals of the EMT.
5. Minimize tax implications for all parties.
6. Ensure that the long-term goals of the shareholders and the EMT are congruent.
7. Attract one or two additional key executive management team members.

Armed with this information, PrivateCo approached Fuller Landau (“FL”) for advice and direction.

After considering the client’s goals, their concerns and their strategic plan, we proposed a phantom stock plan.
**What is a phantom stock plan?**

Essentially, a phantom stock plan is a “right” granted to an employee by an employer to participate in the sale of the business on some defined terms and conditions. The most important term would be the percentage participation that an employee would receive upon the sale of a business or conversely the percentage dilution that the shareholders are prepared to accept.

Accordingly, a phantom stock can be an effective and efficient way to motivate key employees so that their contribution to the business is to increase the value of the company using the “motivation of ownership”.

Therefore, Phantom Shares have the attraction of share ownership when a business is sold without some of the associate implications of share ownership such as: the need to purchase/sell shares; there is no voting interest and it is not necessary to enter into a shareholders agreement.

A phantom stock plan would take into account the following features:

- Vesting.
- Forfeiture of rights in the event of employee resignation or termination.
- Percentages can be increased or decreased.
- Percentages can vary depending upon the employee.
- A valuation methodology is often established tied to the triggering event of a sale of business, e.g. participation in a sale might start after a threshold valuation is established. This is to recognize that a baseline value existed before the employee commenced employment with a business.
- A triggering event could occur if the employee retires, dies or is unable to work due to a long-term illness.
- Recognition that the “right” to participate does not equate to legal title in shares, thereby avoiding any risk that creditors would have a claim on an employee’s assets, i.e. shares.

Phantom stock plans also have several tax advantages that are attractive to both business owners and the key employees.

First, when a key employee receives share rights under a company’s phantom stock program, CRA does not recognize that receipt as taxable income to the employee until he or she actually receives the money. This typically occurs when the company is sold or when the employee retires and is cashed out (assuming all other terms and conditions of the plan are met).

Secondly, although on receipt of the funds, the payment is treated as employment income in the hands of the recipient, the employee benefits from the deferral of tax on the increase in value.

Lastly, the company is entitled to a full deduction for the payment.

Therefore, determining and understanding what your company is worth is essential when setting up phantom stock plans. Unless a business owner has gone through a purchase and sale of the business process or meaningful tax reorganization, they often do not have a true understanding of the value of their business. This is an essential first step before establishing a phantom stock plan.

**Conclusion**

The shareholders of PrivateCo decided to implement a version of the employee phantom stock plan that was tailored to meet their specific needs. They identified a prospective realization plan with an ultimate goal of selling the business within a specified timeframe. The plan was laid out in a document that described who was eligible for the plan, how the plan was to be administered and the many other terms and conditions associated with the “right” to participate.

Retaining key employees will help your business succeed. Fuller Landau can help guide your business, including assisting you in attracting, motivating and retaining key employees.

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