An Alternative to Employee Stock Transfers

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One of the greatest dilemmas confronting employers is whether to give key employees stock in the company as a perk for a job well done. Lately, it seems many employees feel entitled to own stock because of their level of contribution or their years of service.

Generally speaking, it may be unwise to share the stock of your company, even in small amounts, with employees who are not genuine partners in your business. The downside considerations for the business owner typically far outweigh the potential benefits to the employee. Any shareholder is entitled to copies of all corporate financial statements. Furthermore, though the employee may own just a small percentage of stock, he can create big problems for the employer. We've seen many situations in which a small minority owner of a company becomes disgruntled and ties the company up in litigation over his demands, using his ownership interest as leverage.

An employee may enjoy special privileges today because of his or her contribution. That is not to say, however, that the business dynamics will not change, making others' skills more attractive to the long-term success of the company. Naturally, those new key employees would expect the same treatment as the first and, before you know it, your personal business asset could be significantly diminished in its value to you.

There are no perfect solutions to this dilemma, but there is one concept that can be useful in certain situations—a phantom stock plan. A phantom stock plan is a type of non-qualified retirement plan. It is similar to a supplemental executive retirement plan in its general makeup, but the ultimate benefit payable to the key employee is based on the value of the company stock rather than on a fixed benefit amount.

First, a business valuation is performed to identify the fair market value of the business and phantom stock is issued. Because it is not actual company stock, any percentage of the phantom stock could be given to designated employees without creating vulnerability to the owner.

A document is drafted specifying the rights the phantom stockholder has under the plan. Vesting schedules, terms entitling the employee to benefits, and the payout period of those benefits are all variable and can be incorporated to best suit the needs of the company and its owner.

Let's review a simple hypothetical example. We'll assume that an employer gives 5% phantom stock interest to each of his five key employees. We will further assume that the current value of each 5% interest is $150,000 and that the agreement allows the holders of the phantom stock to receive its value in cash over a 10-year period beginning in 15 years.

If the business averages an annual growth rate of 8% for the 15-year period, each of the phantom stockholders will be entitled to $475,000 payable over 10 years. Needless to say, if this ultimate obligation is not planned for properly, a company could find itself in deep financial trouble when these future obligations come due. It is highly recommended, therefore, that a sinking fund be established to accumulate the necessary funds to pay out the obligation. It is also essential that the business is valued frequently, preferably annually, to assure that the future value is forecast with reasonable accuracy.

As in other non-qualified plans, life insurance is the sinking fund product of choice for most companies. This is so because of the tax advantages of cash value life insurance as well as its uniqueness in providing pre-retirement death benefits available to pay the survivor's beneficiaries and ultimate cost recovery to the corporation.

Phantom stock plans are not ideal for every company. But they do offer a viable option to the employer confronting the issue of rewarding key employees without wishing to give up control or privacy. Because the ultimate benefit received by the employee is directly tied to the value of the company, phantom stock plans can also serve to provide incentive for the key employees to help grow the company.

Like all planning tools, phantom stock plans should be instituted only after careful analysis of their usefulness for your particular situation. Please call our office to schedule an appointment for an Employee Benefits Consultation. We can evaluate whether a phantom stock plan or other form of non-qualified plan makes sense for you.