LIFE ADVANCED MARKETS

Key employee compensation strategies

Phantom stock plans

Compensation strategies based on the success of the company

While each of your employees contributes to the success of your business in their own way, you may consider a number of employees crucial to attaining critical business objectives.

These key employees may have unique skill sets, specific knowledge and experience in the industry, or bring valuable relationships to the table. Recruiting such employees, incentivizing them to continue their employment, and motivating them to excel in their roles, requires consideration of various compensation arrangements.

At some point, a business owner may consider granting key employees an ownership interest in the company. While this may provide the employee with an incentive to grow the business and maximize its value, **business owners may want to consider the impact of providing employees with ownership rights in their business.** For example, in many states, minority shareholders have the right to review corporate documents and financials, the right to bring lawsuits against majority shareholders, and possibly even the right to seek a court order dissolving the business.

Fortunately, there are alternative compensation arrangements designed to achieve many of the same advantages that a grant of business ownership may provide – without the potential disadvantages discussed above. One such arrangement is the phantom stock plan.

A phantom stock plan provides key employees with additional compensation based upon the success of the company. The plan is a contractual agreement between a key employee and an employer whereby the employer promises to pay the employee additional compensation at some point in the future, based on the value and growth of the stock of the business.

In order to receive this additional compensation, the employee is typically required to continue employment for a period of time (the vesting period). The employee may receive a payout of their vested account balance upon termination of employment, a predetermined date, death, or permanent disability (depending on the terms of the agreement). The employee is not taxed when their account is credited with phantom stock units; they are taxed when they receive a payout of their account balance. The employer may deduct payments when they are made to the employee.

Product and feature availability may vary by state and broker/dealer.

An example

The Company grants 1,000 units of phantom stock to a key employee. At the time the grant is made, each share of the Company is valued at $30 per share, giving the employee an account value of $30,000. The agreement requires that the employee remain employed at the Company for a period of at least 10 years, at which time the balance of the phantom stock plan will be paid out.

In ten years, the company has grown significantly and each share is now valued at $90 per share and the account value has grown to $90,000 (1,000 units x $90 per share). The Company then pays out the $90,000 to the employee (often this will be done over a period of years). The employee will pay income taxes, and the employer may deduct the payments when they are paid to the employee.[1]

	Year 1	Year 2	Year 4	Year 6	Year 8	Year 10
Stock value per share	$30	$45	$40	$60	$75	$90
Participant's account balance*	$30,000	$45,000	$40,000	$60,000	$75,000	$90,000
% vested	20%	20%	40%	60%	80%	100%
Vested account balance	$6,000	$9,000	$16,000	$36,000	$60,000	**$90,000**

* Assumes an initial grant of 1,000 phantom stock units

ADVANTAGES

- Employee's future compensation increases with the success of the business, providing motivation to grow the business
- It provides a means for key employees to save for future needs (retirement, college expenses, etc.)
- Plan balances grow on a tax-deferred basis (no income tax until compensation is received)
- Employee shares in the success of the business while the business ownership retains ownership of the business

Implementing a phantom stock plan requires the employer to make certain decisions and consider a number of issues. Among the items an employer must consider are the plan design, initial and ongoing costs, and informal funding options. The following is an overview of the various factors to consider in establishing a phantom stock plan.

PLAN DESIGN CONSIDERATIONS

Amount to credit – As a nonqualified plan, there are few restrictions on the amount an employer can credit to a key employee's account. In addition, different amounts may be credited to each participant. The employer will need to determine appropriate amounts to credit based on a number of factors:

- Value of the business today
- Reasonable growth expectations
- Age of participants
- Current compensation of participants
- Value each employee brings to the business

Distribution events – When will the participant have the right to receive a distribution of their account balance? The most common distribution events include:

- Specified date or age
- Fixed schedule
- Death
- Permanent disability
- Termination from service (involuntary)
- Termination from service (voluntary)
- Change of control in company ownership
- Unforeseeable emergency

[1] Phantom stock plans must comply with IRC Sec. 409A rules related to nonqualified deferred compensation plans. Prior to implementing a phantom stock plan, employers should seek advice from their professional legal and tax advisors.

Vesting – Each participant's vested account balance may be available to them when a distribution event occurs. You may create a vesting schedule that limits the portion of their account balance that is available to them for a specified time period. In most plans, when a distribution is triggered due to the death or permanent disability of the participant, the account balance becomes 100% vested, regardless of the years of service.

Valuation – Each phantom stock unit will be valued based on a formula set by the plan document. You have some flexibility in determining what that formula is. The formula should be simple so that the value of each participant's account can be easily, and cost effectively, determined. Some examples include:

1 Unit = 2 Times Net Annual Income (Divided by number of Shares Outstanding)
1 Unit = 1 Times Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) (Divided by number of Shares Outstanding)

INFORMAL FUNDING

Each participant's account balance will be posted on the company's balance sheet as a liability since it represents a future obligation to pay. The employer may wish to set aside funds in order to meet this future obligation. One option to informally fund the liability is for the employer to acquire a cash value life insurance policy, such as fixed index universal life insurance, covering the life of the employee. Such policies may be designed to provide the employer with funds that have the opportunity to grow tax deferred, access to cash values via potentially income-tax-free withdrawals and/or policy loans,[1] and tax-free death benefits should the employee pass away.[2]

Considerations when utilizing an FIUL policy

- Employee must be insurable
- Life insurance requires health and financial underwriting
- Consult with your financial, tax, and legal professionals when exploring this strategy

COSTS/ADMINISTRATION

An employer will incur certain costs when establishing and administering a phantom stock plan. Costs that the employer should consider include the following:

- Initial legal fees to draft the plan document
- Professional valuation fees – This will only be the case in plans that contain valuation formulas that value a unit based on variables such as book value, good will, etc.
- Human resources time – Depends on how often the employer wishes to communicate plan account balances with participants. With a simple valuation formula and annual statements to the participants this should be very minimal.

Once the plan is in place there are very few ongoing decisions to be made other than whether or not to grant additional units. Keep in mind that while the employer reserves the right to amend certain features of the plan, the employer may not take away an existing right. In other words, you may change how the plan functions in the future (units granted, formula, vesting, etc.) but you may not go back and reduce the amount due to a participant.

For more information on how FIUL could fund phantom stock plans, **CONTACT YOUR FINANCIAL PROFESSIONAL.**

[1] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

[2] Employers must comply with the notice and consent requirements of IRC Sec. 101(j) in order for the life insurance death proceeds to be received tax-free.

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