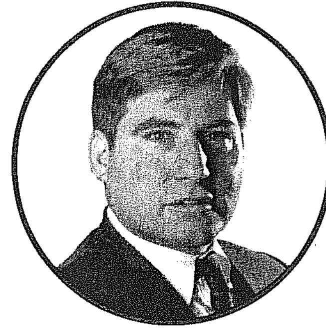
Phantom stock gives family firms a leg up

Changes in tax and securities laws have made this pay strategy even more effective in luring key recruits.



BY ROBERT A. ADELSON

WITH THE STOCK market apparently recovering from the "dot-bomb" crash of 2000-02, many companies are again using stock to lure top executive talent. If it's time for your family business to recruit key technical employees or senior executives from outside the family, how can you compete with these non-family firms? What can your company offer prospective employees instead of stock or options?

As employee appetites for stock and options rise anew, it's important for family businesses to meet the competition by offering their own form of equity—without actually transferring ownership. The good news is that today's tax climate has made it easier for family firms to compete in the recruitment wars—and the benefits are likely to continue regardless of the outcome of November's Presidential election.

Recruiting talent from outside the family

Your business may not be able to grow or face tougher competition if there are gaps in your family members' knowledge, skills or experience. The best way to fill in the missing pieces is by hiring non-family employees.

Even if there is no gap, it may be wise to recruit a senior manager to help train and mentor the next generation in preparation for a leadership transition—someone who would also be available to step in if illness, disability or death strikes a core family member.

Unfortunately, a family business's stability and long-term perspective, while attractive, don't go far enough to lure potential recruits. A non-family executive may fear that nepotism and family loyalty may trump sound business judgment. Hopefully, if you are seeking non-family talent, your company can allay these concerns by citing its record of putting growth of the business before the personal concerns of the family owners.

Offering a stake in the upside

But even if you can show a track record of growth and sound judgment, there is something else that might make non-family candidates skittish about joining your company: the perception that because they are non-family members, they won't get to share in the benefits of their hard work.

Because most family business owners want to ensure that their company stays in the family, they don't offer their non-family employees the opportunity to own stock. But there are ways to give non-family executives a share in the rewards of ownership without actually transferring even one share of family business stock.

The three strategies outlined below—particularly the phantom stock approach—are powerful weapons in your arsenal. Changes in federal tax and securities laws have made these alternatives even more attractive.

Non-voting stock and 'rabbi trusts'

One option is to institute a non-voting stock plan for key non-family employees. Non-voting shares are allowable in LLCs, C corporations and even S corporations. This structure provides for all the capital appreciation of normal shares and permits shareholders to take advantage of the record low 15% tax rate on capital gains and dividends. Under this arrangement, non-family executives have no voice in the company's operations and strategic choices.

The second approach is a

non-qualified deferred compensation plan, which can provide a secure future payout to a key executive. Taxation to the executive is deferred via a "rabbi trust," a trust that is set aside for the employee but remains subject to company creditors. (It was first used for a rabbi and the nickname stuck.) The plan can include "golden handcuffs," or vesting arrangements in which benefits are lost if the executive leaves the company. It can also include "bad boy" provisions, in which benefits are forfeited if the executive violates confidentiality or non-compete agreements or other company rules and restrictions during employment or post-termination.

Phantom stock: The most far-reaching solution

The third approach—a phantom stock plan, taxed in the same manner as deferred compensation—combines the first two. As the most far-reaching and innovative solution, it offers the family firm a real advantage.

Under a phantom stock plan, the company sets a share value benchmark at the time phantom shares are issued (phantom strike price). The phantom stock contract issued to the executive provides a vesting and redemption schedule as well as a method of future stock valuation. If the executive does a good job and the family business prospers, when redemption occurs the executive will be paid an amount equal to the value appreciation. That is, the executive is paid the difference between the share value on the date of "sale" (phantom stock redemption or payout date) and the original phantom strike price. This spread is the same kind of payout the executive would achieve if he or she had conventional stock options in a non-family business.

A phantom stock plan can generate both phantom dividends and phantom capital gains.

A family company's phantom plan not only offers key employees a share in the company's growth but also can do so on far better terms than plans offered by non-family competitors. Here's how.

Sarbanes-Oxley and phantom stock liquidity

Many small public companies are going private or delisting their securities rather than face the heavy costs of compliance with provisions of the Sarbanes-Oxley Act, passed by Congress in response to several high-profile corporate scandals.

Executives at those companies will now have equity that is illiquid. This gives closely held family businesses a distinct advantage in recruitment. A well-designed phantom plan provides liquidity (i.e., an exit strategy) for executives that small-capital companies no longer offer.

Phantom capital gains vs. incentive stock options

A phantom stock plan can generate both phantom dividends and phantom capital gains by taking advantage of the deductions available in the tax law and sharing the benefit with key hires.

Under the 2003 tax law, capital gains are taxed at 15%, the lowest rate since 1933. Dividends also are taxed at 15%, the lowest rate since the introduction of the graduated income tax in 1916.

Plans that provide incentive stock options rarely allow executives to take advantage of capital gains or dividend tax treatment. Under today's tax law, this is a huge lost opportunity.

What if Kerry wins?

At this writing it's unclear who will be the next President, but the benefits of phantom stock appear likely to continue, whatever the outcome of November's election.

If President Bush is re-elected and the Republican majority holds in Congress, the thrust of GOP tax policy in 2005-09 will be to make permanent the recent Bush tax cuts—including those for capital gains and dividends that are scheduled to sunset during that '05-'09 period. There will also likely be a push to eliminate tax on dividends.

Democratic candidate John Kerry has proposed rolling back Bush's tax cuts for families earning more than $200,000 and creating new tax

incentives for employers to hire new workers.

A well-designed phantom stock plan will withstand any changes in tax policy. Since a phantom plan provides for income deferral, it will be possible in many cases to keep key employees' income below the $200,000 ceiling that Kerry proposes. Also, to the extent that phantom stock aids hiring, it could help a family business owner earn a tax credit.

A case example

An established family business (FamCo) has outgrown its current management and wants to recruit a chief operating officer from outside the family. The top candidate knows the industry, has managed a larger work force with multiple offices and has proved his ability to take a company to a new level.

The current family CEO, at age 70, is looking toward retirement. The prospective COO, Tim Atkins, is 55 years old. Hiring this key player would bring new vigor to the company. The parties hope to see FamCo grow from its current valuation of $5 million to $10 million over the next decade.

FamCo offers Tim Atkins phantom stock that matches his annual salary of $200,000. During each year of a five-year contract, Atkins receives phantom stock units at a strike price of $5 per unit with the units vesting annually at 20% (half the vesting based on his remaining with FamCo and half based on achievement of his performance goals). In ten years, when Atkins retires, the company would again be valued and Atkins paid on the growth of his vested units, with a buyout over ten years.

Thus, if Atkins stays with FamCo 4½ years, he accumulates 160,000 units. In that time, for example, if he achieves half his business targets, he'll vest 60% of these units (vesting 80% based on four years' tenure and 40% based on meeting half his targets). When he leaves after 4½ years, 96,000 phantom stock units are vested (equivalent to almost 1% of the company) at the original $5 per unit. Atkins has no voting rights or rights to stock, but—assuming he doesn't violate company covenants—he will receive a future payout for the units.

Although a family company incurs the cost of paying out phantom stock, it derives a greater benefit from non-family executives' contributions.

Now suppose that because of Atkins' achievements over those 4½ years, FamCo grows from a $5 million company to a $15 million company by 2014. The stock price (and, thus, the phantom unit value) grows to $15 per share. Under the plan, Atkins would be paid off at the spread between the $5 original strike price and the $15 current market price in 2014. With a $10 spread per unit, the payout on Atkins' vested units would be $960,000, which would be paid over ten years with interest on the $960,000 note at the *Wall Street Journal* prime rate.

Under a phantom capital gains plan, the tax deductions generated by this payout would be shared between FamCo and Atkins to reduce his tax from 35% to 15%, thus achieving effective capital gains treatment on the payout, under the current low capital gains rate. Because the income from the phantom stock is spread over ten years at $96,000 per year, Atkins would be taxed at the lower rate even if a President Kerry were to roll back tax rates for those earning more than $200,000 per year.

This example works for any family business in any American industry, whether the business valuation is $5 million or $5 billion. Although the company must incur the cost of paying out phantom stock, it derives a much greater benefit from growth. These plans give family-owned companies the ability to recruit and retain key talent, which more than offsets the cost involved. FB

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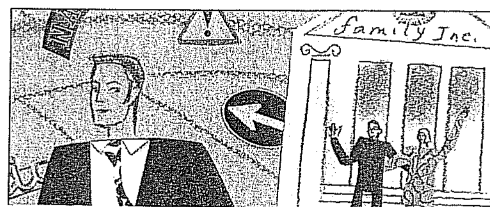

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CORPORATE, TAX AND BUSINESS TRANSACTIONS

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