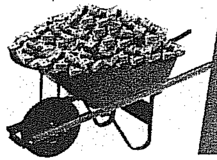


MONEY-PRENEURING

This pay strategy can lure key recruits thanks to changes in tax and securities laws.

By Robert A. Adelson

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.

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.

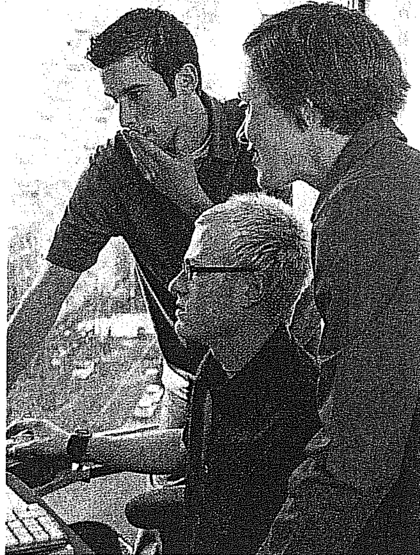
Your business may not be able to grow or face tougher competition if there are gaps in your family members' knowledge, skills or experience. The way to fill in the missing pieces is by hiring non-family.

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, death or disability strikes.

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 supercede 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 as 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 below—particularly the phantom stock approach—are powerful weapons in your arsenal. Recent changes in federal tax and securities laws have made these options even more attractive.

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.

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 New York 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.

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 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.

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 liquid. 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.

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

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