Reward for the Long Haul

Compensation plays an obvious role in motivating employees — but to do what? That largely depends on how it's structured.

Some comp plans result in the loss of good people — after a few years of good money and on-the-job training, employees punch up their resumes and move on. But compensation can also be structured to build loyalty and enlist employees for the long haul.

Company stock is the most common way to do this, and its message is transparent: Work hard and we'll all prosper. But it dilutes ownership, and that's too high a price for many business owners. They want to tie rewards to the company's success, not give up control.

Qualified profit-sharing plans are popular, but these plans can end up favoring younger, lower-compensated employees who leave the company before retirement — the opposite of the behavior the owner seeks.

Enter the Phantom

A phantom stock plan offers another solution. It rewards employees not with company stock, but with a deferred amount that's *indexed* to company stock. When the employee actually takes possession, he or she enjoys tax benefits similar to those accorded other deferred compensation.

Since the value of the phantom stock rises or falls with the company's success, it strengthens the employee's interest in building the company. When capital structure changes, phantom stock adjusts — a split in common stock splits phantom stock, too. And when common stock earns dividends, the value of phantom stock increases proportionally.

Pros and Cons for Employees

When employees take possession of the deferred payments, they receive cash, not stock. They benefit from their company's success but aren't forced to invest in it.

Further, employees can avoid taxable income — a clear advantage over some stock options that require recipients to report income and pay taxes on it before they actually receive it.

But phantom stock, like certain other deferred compensation, can limit career moves. Many plans require that employees must remain with the company for an extended period and sign broad noncompete agreements in order to receive actual funds.

New Rules in Effect

In the American Jobs Creation Act of 2004, Congress made changes to deferred compensation rules. In order to provide tax-deferred income, a phantom stock plan must meet certain new requirements:

- Limit distributions to one of six events: 1) the passage of a specified time, 2) death, 3) disability, 4) separation from service, 5) unforeseeable emergency or 6) a change in corporate control.
- Prohibit acceleration of benefits, a move that formerly incurred only a small penalty.
- Require timely election by employees, prior to the year in which the deferred compensation is awarded.

Plans that fail to meet these requirements will cause phantom stock monies to be included in taxable income — retroactively — and expose the funds to a 20 percent excise tax and interest charges.

Our firm can educate you about the advantages and drawbacks of various compensation options. Give us a call to learn more.