Transform Select Employees into "Owners" Without Diluting Corporate Control

The Exquisite Reality of Phantom Stock

An Informative White Paper for the Owners of Private and Closely Held Companies

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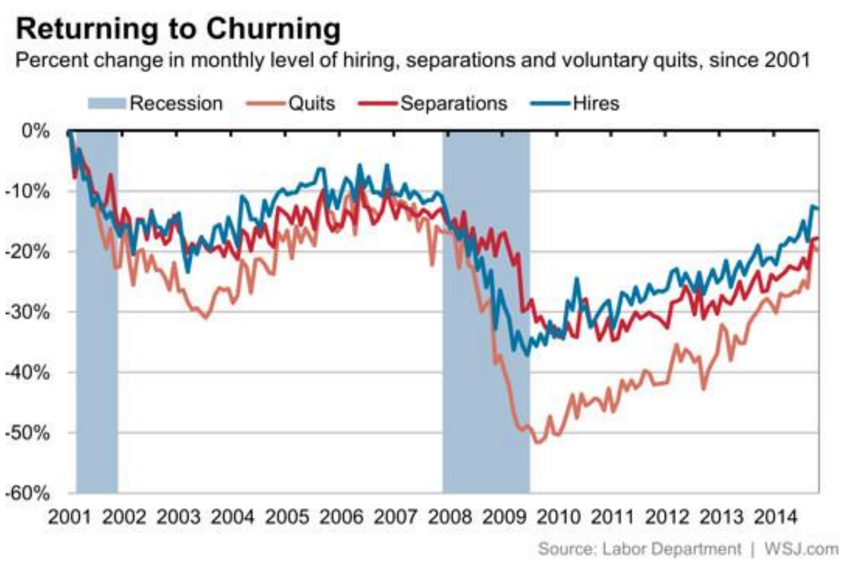
In business, size matters, especially when your company is at a disadvantage. Mid-size companies face a serious challenge from larger and smaller competitors to attract and retain top-performers, the executives or key employees, who make a measurable difference in corporate growth; they're the drivers of progress and revenue. And you can't afford to lose them.

The tenuous depth of corporate talent pools preoccupy major companies today. *Fortune Magazine* cited an important 2006 survey by outplacement experts that supports the claim: 77 percent of companies admitted they do not have enough successors lined up to replace their current senior managers.

This vulnerability has only gotten stronger. As of October 2014, “the number of people leaving their jobs climbed to the highest in more than five years, according to the Labor Department, another sign of a labor market gradually returning toward normal more than five years after the official end of the recession, as reported in a *Wall Street Journal* article December 9, 2014.

In that same article, it was reported that some 4.8 million people left their jobs in October, half of which were voluntary separations. Note this chart:



People are on the move. It’s safe to say that a concerning number of your employees are thinking about leaving the company for better jobs.

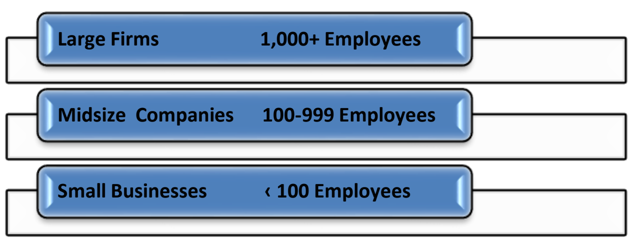
Jim O' Sullivan, the chief U.S. economist for High Frequency Economics, claims *"the more people quit, the more incentive there is for employers to reward people for staying proactively."*

Larger, publicly-traded companies can attract top-performers with generous benefits like full stock grants or stock options, restricted shares or other forms of long-term equity compensation. Smaller companies attract top-performers with innovative, fast-paced cultures and ground-floor IPOs. Mid-market companies must deflect both sides to retain their talent. Star contributors are fair game for corporate poachers. And star contributors typically see instant gratification and will jump ship for a better offer.

How then can owners of mid-size companies incentivize top-performers to drive revenue and stay with the company without giving stock and watering down control of their companies?

We answer this question in this paper and show you how to secure funding for your long-term benefits program from an unexpected source. *Read on.*

First, let's define the term midsize company. Typically, these companies support workforces of fewer than 1,000 employees.



In terms of revenue size, definitions vary widely from $5 million to $3 billion. Many financial professionals consider middle market from $5 million to $100 million and $100 million to $500 million, as well as up to $3 billion.

It is to the valiant owners of these middle market companies that we speak. You've heard the expression *'Everything has its price.'* When it comes to employee compensation and benefits—one of the heaviest burdens on your balance sheet—you can grow your company and share the bounty with those who helped get you there or who will help you get there in the future. And without paying the price of diluting stock or giving up any measure of corporate control.

The key is to use the alchemy of ownership to turn your key employees into like-minded owners, wired to build, grow and sustain the company as you have done for many years.

The Psychology of Business Ownership

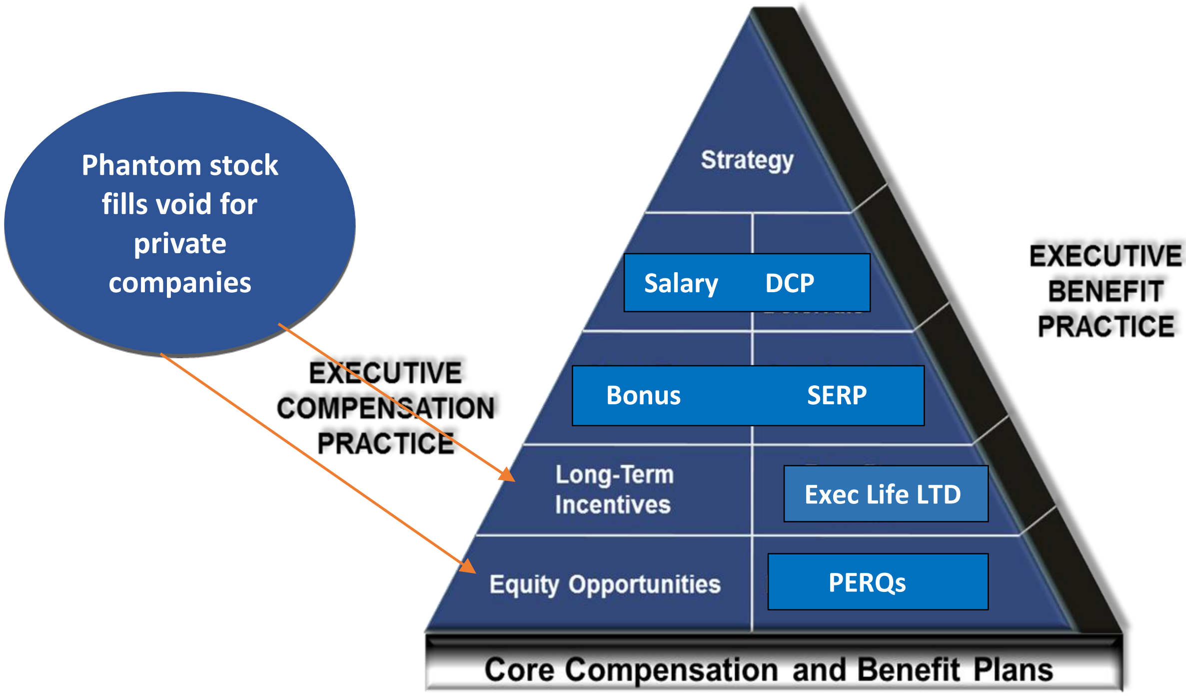
Any business owner who has built a multi-million dollar company, and I've built three, has thought countless times: *"If only my employees could walk in my shoes, they'd get it, they'd feel my passion and commitment."*

To build a business is a heroic endeavor. You yearn to create something. You hold passion for the commitment. And you don't blink over tough decisions. You stretch way past perceived limitations. You see problems as opportunities, competition as motivating, and making money as exhilarating. You're resilient. Consistent. Integrity rules your thinking and behavior. Can this be taught? Are entrepreneurs born or made?

What you can do is influence behavior with the right mixture of leadership and reward. You can act now to make your entire team of highly compensated employees feel like owners. While some owners may find this idea anathema to their need to be the only man or woman at the top, many others thrill to the idea that they could share their creation with no strings attached in exchange for corporate growth.

If they only knew how.

But first, a super-short lesson on how to view executive compensation and benefits. Picture two supporting beams of long-term structure as in the chart below. Now pay close attention to the lower left corner.



When top management, highly compensated employees or financial advisors review employee compensation plans, they look to balance both sides of the equation. For large, publicly traded companies, management can issue ownership to key employees in various equity and long-term incentive plans. This opportunity is where midsize companies struggle. Phantom stock can be the replacement for the lower left corner, without giving up ownership control or voting rights.

In best practices, compensation and employee benefits ought to fit in to a company's integrated total rewards program. Why? Because well-designed compensation, especially stock awards, and employee benefits balance the total compensation and benefits strategy. Now, with phantom stock in its compensation mix, small to midsize companies eliminate their historic disadvantage.

By combining compensation and benefits, your company will be able to focus clearly on reaching its business objectives and desired behavioral outcomes of the top talent that contribute to your profitability.

Now let us turn to the type of long-term incentives in play, then single out one that can become your secret weapon. Briefly, we're going to describe stock grants, phantom shares, and phantom stock option plans.

Full Value Stock Grant

This type of stock is common currency among large, publicly traded companies. These companies can use this currency to attract and retain key executives. To illustrate, I'll use the pseudonym Agilon Technologies to discuss how the CEO, Bob Sheridan, and his compensation committee, decide to put a golden handcuff on his senior vice president of sales, Margaret Sterling.

Sheridan arrives at a long-desired milestone, $20,000,000 in revenue. He decides to give Sterling 10,000 shares in the company valued at the full price of $15, subject to certain provisions and a vesting schedule.

The day arrives when she is fully vested in those shares granted, usually five years. The stock now has a market value of $20 per share, so her shares have a market value of $200,000. She can cash those shares in or hold them for long-term gains. The stock grants are over and above base salary, short-term bonus and other attractive benefits offered by the company. And those grants are not just given out once, they're part of the company's long-term incentive compensation strategy.

So how do privately held companies compete as it relates to long-term incentive plans and equity compensation? The Phantom Stock Option Plan.

What is a Phantom Stock Option Plan?

This form of employee benefit plan gives select employees and senior management many of the benefits of stock ownership without giving them any company stock; it's sometimes referred to as "shadow stock," defines *Investopedia*. "Rather than getting physical stock, the employee receives "pretend" stock. Even though it's not real, the phantom stock follows the price movement of the company's actual stock."

Phantom stock is a contractual agreement between a corporation and recipients of phantom shares granting employees the right to a cash payment at a designated time or in association with a designated (trigger) event in the future. The payment amount is tied to the market value of an equal number of shares of corporate stock.

The payout amount increases as the stock price rises and decreases if it falls—remember, the recipient does not receive actual stock or have any of the rights of shareholders.

Similar to other stock-based compensation plans, the mission of phantom stock brings alignment between employees and shareholders, adds to share value, and encourages retention of employees, managers, directors or even third-party vendors.

Many factors come into play when designing and implementing a phantom stock plan such as the company business strategy. Phantom stock plans also take many forms, which we discuss later in the paper, including valuation, participation, and allocation of shares, redemptions, timing, dividends and vesting, all of which affect plan success.

Types of Plans

Phantom stock programs include performance phantom share plans, phantom stock options (appreciation only) and full value phantom plans as follows:

Performance Phantom Share Plan (PPS)

PPS plans are performance-contingent, pay denominated in phantom stock and earned over a performance period, if certain performance goals are attained. The performance period typically is a three to five year duration. Grants are usually made every year as continuing incentive device, which results in overlapping performance goals.

This type of plan contains two distinct performance-based factors. First, the key employees must reach certain pre-determined performance targets to be awarded phantom shares. Companies are adopting this type of structure because they want to tie the plan to factors the employee can control, such as revenue growth, net income, and more. You can vary the shares by employee and by how fully the targets are reached. Financial targets include such measures as pre-tax income, revenue increase or EBITDA.*

***earnings before interest, taxes, depreciation and amortization**

The second performance factor rests on the potential improvement in value for phantom stock value appreciation. Once awarded, phantom shares may still remain subject to vesting schedules or other restrictions. The tax effect on employees mimics phantom stock, resulting in ordinary income taxation to employees when they convert to an actual cash payment.

Case Study: Financial Services Company

The company designed the plan for the top 10 senior managers out of a total employee base of 1,200. It looked at using two financial matrices (EBITDA and revenue) as the performance targets, but settled on one to keep the plan simple—gross revenues. They set the target at 20% average annual growth of revenue with a three-year measurement period to earn the award. Each unit granted had a three year vesting period, and paid the award in cash at the end of year five. Even though the target was set at 20% revenue growth over the three-year period, it did pay a lesser reward for growth above 7.5% (25% of target), and a higher reward for growth over 20%.

As an example, in year one, employee A was given 100 units worth $1,000 each. At the end of three years, the company met 75% of target (i.e., 15% growth); therefore, his reward was $75,000, which would be paid in cash in year five. In the second year, the executive was given another grant of 100 units for the second three year cycle (units awarded could be zero or any amount determined by the company).

During this three-year period, the company exceeded the target of 20%, actually hitting 25% growth (150% of target) so the reward was worth $150,000 which was paid five years from the grant date. The company informally funded the plan with corporate-owned life insurance (COLI) to hedge the liability and have cash available during the payout periods.

Full Value Phantom Stock

This approach offers another reward mechanism for deferred compensation, which creates a similar result to restricted stock. The sponsoring company determines a phantom stock price for the shares either through a formula or outside evaluation (valuation discussed later).

Employees are awarded some number of phantom shares that may carry specific terms and conditions. At some point, active employees receive a cash payment equaling the value of the original shares plus the appreciation. For example, assume an employee receives 1000 shares of phantom stock with a starting price of $10. At a pre-determined future date, the company calculates the value of the phantom stock price and pays the employee the full value.

Assume, for our example, the share price grows to $25. The company will pay the employee $25,000. The phantom stock plans do not result in shareholder dilution because actual shares are not being transferred. Employees do not become owners per se, but they do realize the same results as if they owned the shares.

Case study: Medical Research Company

This company designed a plan for the CEO (hired professional) and his six direct reports. The company allocates 12.5% of "units" for the Board Compensation Committee to issue at its discretion, on the CEO's recommendation. The shares (units) are valued at entry to the plan, typically within one year of employment, and then are revalued annually. The vesting period is seven years.

Valuation equals seven times EBITDA plus cash less interest-bearing debt. Unit valuation is determined at entry, and is subtracted from the unit value at exit (resignation, retirement, termination), and the difference is multiplied by the number of units allocated to each person. Typically, 1-1.5% per person allocated depending on his or her role.

Phantom Stock Option Plans (PSO)

Here comes the crème brûlé in our stock confection. A phantom (faux) stock option plan offers an equity-flavored incentive analogous to a stock option plan in a publicly-traded company. PSO plans solve the corporate owner's need to retain control of what he has built and simultaneously keep employees motivated and invested in their contribution to corporate growth.

So, like a stock option plan, a PSO plan gives the employee the right to purchase shares at today's price (without issuing real shares). Example: The employee is awarded 1,000 phantom shares currently priced at $10. He may purchase them now, or wait until the end of the vesting period when he would expect appreciation in the shares, say five years. If he waits, and at the end of the vesting period, the share price is $16, the company would pay him the spread of $6,000 (the difference between the purchase price ($10) and the current price ($16) times the number of shares).

PSO plans work much like stock appreciation rights (SAR) plans where the employee receives the appreciation versus the full value.

Case study: Software Development Firm

The company designed a plan for its vice president level and above executives (approximately 50 people). Awards were offered annually based on company and individual performance. Vesting was over three years for each block of grants and cash payments were scheduled to begin in year four.

The company allowed employees to tax defer payouts into the company's nonqualified deferred compensation plan which allowed a menu of mutual fund investments with various payout options, including at retirement. The shares were valued at five times EBITDA. With the three year rolling vesting schedule (every grant vests over three years) the employee would always leave cash on the table if he or she left the company.

Consider Intent First

Before deciding which plan direction to pursue, consider your objectives for the plan by asking yourself a few practical questions:

Do you want to reward your select group for past contributions to company success or future contributions? What are realistic retention targets?

Are intended participants in the plan new to the company or long-term employees? What's the composition?

What matters more to you—preserving or growing company value?

Are there strategic as well as financial goals that should be included among the performance criteria?

Phantom Stock Fits

If you are serious about a balanced and effective long-term incentive plan, then seriously consider issuing phantom stock. Again, this approach is beautifully designed to motivate and retain key employees without sharing company ownership.

Such plans have the potential to yield payoffs similar to equity grants or stock options. By building phantom stock in to your benefits strategy, you can pass along the same financial reward to consistently valuable executives or employees without incurring any of the risks or complications typically associated with equity sharing.

How Phantom Stock Works

Let's master the internal workings of phantom stock. Imagine that you want to incentivize a top-performing employee to ensure long-term loyalty. You give him or her a bonus amount based on the market appreciation value of your company's stock over a certain period, and proportional to his or her salary level.

The whole objective is to instill your ownership behavior in your select group. If they hold skin-in-the-game through stock, then we presume the sense of responsibility that comes with ownership will spur them to hold the interests of the company above their own and grow its value.

Diamond in the Rough

Phantom stock is the diamond in the rough of executive compensation and benefits. Conventional wisdom says give stock to incent ownership. That may be true if you are planning an IPO. But outright stock grants bring headaches. For example, when you share actual equity with executives, you're required to open the books, give ownership rights, and pay dividends. Worse yet, you will give up some control of the stock and interest in the company. *Why do that if there's a smarter solution?*

The application of phantom stock is simple and straightforward. Many forward-thinking companies establish a formula that provides some retirement benefits to the "employee stockholder." This action strengthens employee retention and further enforces a non-compete provision that extends beyond employment years.

Imagine a company setting up a 10-year plan with the employees in position to earn stock equal to one to ten percent of the company's assessed value. At the end point, the employees cash out over a 10-year period, and collect not more than 10 percent of his or her accumulated value each year.

All-Important Plan Design

Let's discuss the appropriate design of an effective phantom stock plan. When you issue phantom stock, you also develop the building blocks of deferred compensation which, in turn, produces tax-deferred wealth accumulation and retirement advantages.

Select the design that best fits your company’s objectives. If you're not sure which type of plan design to use, consider going with the phantom stock option design to award the appreciation in value of your company. There is less risk in this design: no increase in value; no payment to the employee.

There are five basic steps to plan design. First determine, and then designate, a foundational value to each unit/share equal to the value of company common stock. To establish company value, a formal appraisal is best, however most companies use some multiple of EBITDA or net earnings. You may want your formula value of the stock to be a number less than the market value you might use to sell the company one day. The employee-participant can always realize that value if you sell the company.

Real Valuation

The determination of corporate worth is essential when setting up phantom stock plans or any other financial arrangements. In our experience, owners sincerely believe they know and understand their company's value but, upon closer assessment, discover they are off the mark. In our firm, we regard it a sound business practice to retain an outside valuation firm for your appraisal. We can recommend excellent providers to you. Identify the composition of your select reward group. Typically, if your workforce equals 1,000, you would not number the highly compensated group more than 10 percent, just as you would in a nonqualified deferred compensation plan. However, from our experience a 1,000 employee company typically would have much less than 10% of the employees in such a plan.

Be sure this exercise meets the requirements of the Department of Labor guidelines for nonqualified plans to avoid any potential for ERISA penalties. Start with a small group and expand as time goes by. It's always easier to expand the group than contract it.

Next, award these unit shares to select employees as deferred compensation by your compensation committee. Don't do one-time grants. Set up a pool and a schedule and award grants annually. We have found this to be the best way to continue the motivation for key employee.

Let's say you decide on 10 million shares. Remember, this does not equate to actual shares. This award can be distributed over a period of time. You are only creating an attractive reward for employees in the future, not actual stock. Here's a rough formula based on EBITDA:

*EBITDA	Shares selected
Multiple selected	5
Formula Value	$100,000,000
Shares selected	10,000,000
Shares price	$15

Multiple advantages result from these actions. In general, stock ownership motivates an employee to improve performance and company profitability. With this stronger financial bond to the employee, the employer-owner gains a competitive edge or 'glue in the seat' to hold onto to his best employees for a longer period than thought possible. Vigilance is called for here because executive search is quite active in most business sectors, particularly healthcare, financial services and technology.

Redemption/Distribution of Shares

Once you have granted the shares, spell out your plan and indicate when the executive can cash in his/her shares. Remember, in most cases, phantom stock is settled in cash. So, a plan design could indicate payments due in say five years. Once that date arrives the sponsoring company then calculates the amount due and makes a payment to the employee, normally in cash. The payment processes as any other compensation, and taxes are withheld.

The plan document should also spell out in greater detail how payments are made under various triggering events such as:

- In-service events (allowing payment while still employed)
- Separation of service (voluntary)
- Separation of service (involuntary)
- Termination for cause
- Retirement
- Disability
- Death
- Leave of absence (with pay and without pay)
- Change-in-control
- Termination of the plan

Payments can be structured as a lump sum or over a period such as 5, 10 or 15 years. When doing so, companies need to determine whether such installment payments include interest or whether the employee payments remain subject to fluctuations in value (under the plan formula).

Dividends

Most plans do not pay dividends, although they could. In our study of companies with phantom stock plans, one company paid a dividend that was a percentage of pre-tax profits. Management felt that the plan could produce more value if it also had a short-term year to year focus on pre-tax profits.

Vesting

We arrive now at the final step in plan design—vesting. Since we're discussing a nonqualified plan, you are not subject to the required vesting schedules in qualified plans, though your vesting schedule should reflect your plan goals.

The most prevalent vesting schedule is three, four or five years. However, the impact is different depending on the vesting approach. As an example, your plan could feature a five-year cliff vesting schedule which means at the end of five years the employee is 100% vested in all shares granted. Alternatively, you could have an award vest 1/3rd, 1/3rd, 1/3rd, or 20% a year for five years.

Or, the company could have a class-year vesting schedule, which means if the company grants 100 shares this year, those grants will vest in five years. Then if they grant an additional 100 shares next year, those will vest five years later, which is six years from today. This laddering effect compels the employee to always leave something on the table if they leave early.

Most plans offer accelerated vesting for events such as death or disability of the employee or change in control (COC) of the company. On COC, you need to define what that means; for example, major shareholder selling more than X amount of their ownership or outright sale.

Other factors to consider when designing your plan:

Dark Cloud—Tax Treatment

Plan and participant taxation may give pause. Tax and regulatory requirements tend to cast a seemingly dangerous dark cloud over phantom stock. For example, the cash accumulated to pay for the benefit may be subject to an excess accumulation earnings tax (a tax applied to setting aside too much money in reserve versus using it for business needs).

From a tax standpoint, phantom stock plans are treated like nonqualified deferred compensation (NQDC) arrangements. In general, they are subject to Section 409A, which includes detailed provisions regarding the timing and form or distributions. If benefits are paid out when vested, however, Section 409A would not apply. If payments are deferred beyond the vesting date, or if the awards are linked to a deferred compensation plan, then Section 409A would apply.

If a plan includes deferred payment options (beyond the vesting date), and is in compliance with the requirement of Section 409A, then taxes are not due by the employee until triggered by the actual receipt of benefit payments. At this point, the company is entitled to a tax deduction, but only in the year the payment is physically made.

FICA taxation is different, however. Whether or not the payment of awards is deferred, FICA and Medicare taxes are due and payable upon vesting.

Recognize that no taxable income can be reported or deducted when contingent credits are made to a participant's account. This is why it is important to project out how large this liability can get, as eventually cash must be available to make the benefit payment.

EBS, with its **Phantom Stock Modeler**, can help calculate various scenarios toward growth. In fact, you can participate in a live-action demonstration of our proprietary as we build various scenarios. To give you a sense of the data output, sample screen shots follow:

Valuation

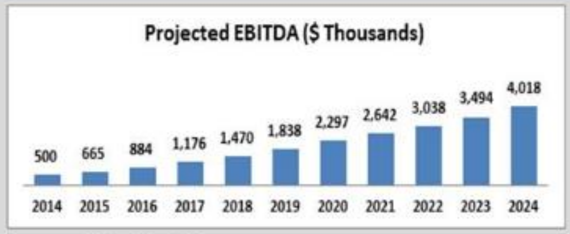
Phantom Stock Plan Modeler — EBS Executive Benefit Solutions

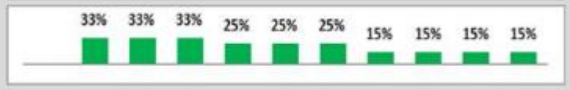
Summary | Valuation Method | Participant Awards | Participant Values | Cash Flow

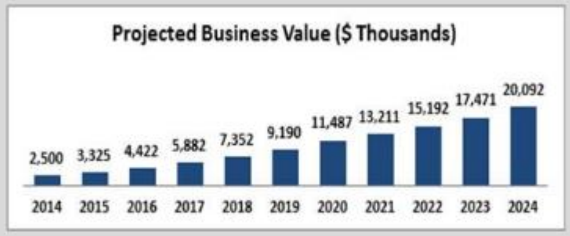
Define the Basis for Valuation	
Select Measurement Criteria	EBITDA
Input Current EBITDA	500,000
What year is this for?	2014
How many future years do you want to model (3-10)?	10
Project EBITDA using Single Rate or a Rate Table?	Rate Table
Click on the Hyperlink to go Rate Table	Go To Rate Table
For Graph, use Actual (1), Thousands (2) or Millions (3)	2

Specify the Valuation Multiple	
What Multiple of EBITDA Would a Buyer Pay?	5.00
How many total shares are there?	100,000

Specify the Vesting Time Period & Schedule (if not Cliff Vesting)	
Select Number of Years to Vest (3-10)?	5
Default is Cliff Vesting or Choose Vesting Schedule	Cliff Vesting
Click on the Hyperlink to Enter the Vesting Schedule	Go To Vesting Table







Summary | Valuation Method | Participant Awards | Participant Values | Vesting | Cash Flow | Variables | Calcs | Rati

Participation Awards

Phantom Stock Plan Modeler — EBS Executive Benefit Solutions

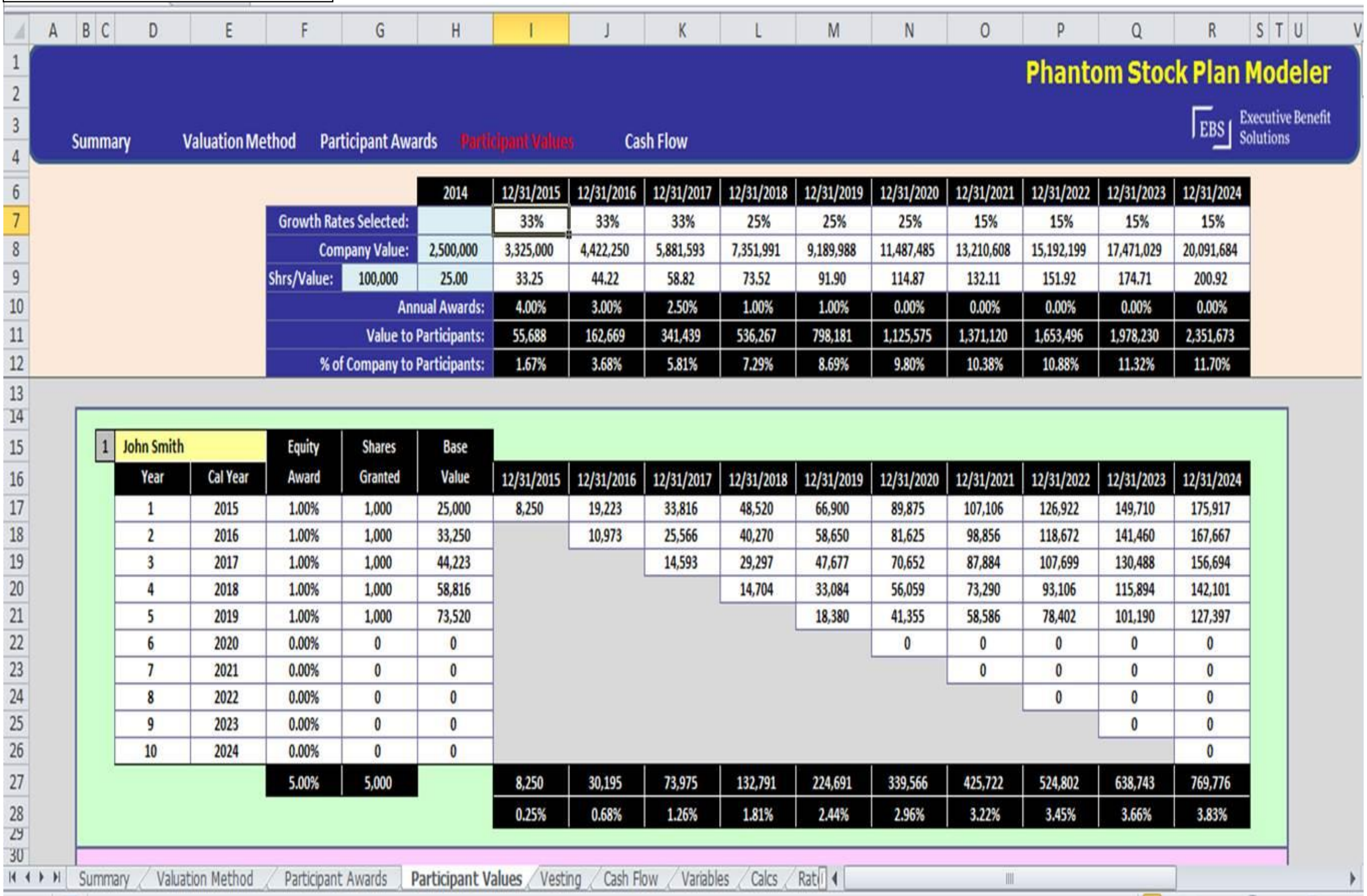
Summary | Valuation Method | Participant Awards | Participant Values | Cash Flow

#	First Name	Title	Salary	Bonus
1	John Smith	COO	350,000	150,000
2	Jim Douglas	CFO	325,000	125,000
3	Jane Doe	SVP Marketing	300,000	100,000
4	Nancy Jenkins	SVP Manufacturing	275,000	85,000
5	Jack Jones	SVP HR	250,000	75,000
6				
7				
8				
9				
10				

Phantom Stock Awards										
	1	2	3	4	5	6	7	8	9	10
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
	1.00%	1.00%	1.00%	1.00%	1.00%					
	3.00%									
	2.75%									
		2.00%								
			1.50%							
<==Annual Awards	6.75%	3.00%	2.50%	1.00%	1.00%	0.00%	0.00%	0.00%	0.00%	0.00%
<==Cum Awards	6.75%	9.75%	12.25%	13.25%	14.25%	14.25%	14.25%	14.25%	14.25%	14.25%

Summary | Valuation Method | Participant Awards | Participant Values | Vesting | Cash Flow | Variables | Calcs | Rati

Participant Values



Phantom Stock Plan Modeler

Summary | Valuation Method | Participant Awards | Participant Values | Cash Flow

EBS Executive Benefit Solutions

		2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	12/31/2020	12/31/2021	12/31/2022	12/31/2023	12/31/2024
Growth Rates Selected:			33%	33%	33%	25%	25%	25%	15%	15%	15%	15%
Company Value:		2,500,000	3,325,000	4,422,250	5,881,593	7,351,991	9,189,988	11,487,485	13,210,608	15,192,199	17,471,029	20,091,684
Shrs/Value:	100,000	25.00	33.25	44.22	58.82	73.52	91.90	114.87	132.11	151.92	174.71	200.92
Annual Awards:			4.00%	3.00%	2.50%	1.00%	1.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Value to Participants:			55,688	162,669	341,439	536,267	798,181	1,125,575	1,371,120	1,653,496	1,978,230	2,351,673
% of Company to Participants:			1.67%	3.68%	5.81%	7.29%	8.69%	9.80%	10.38%	10.88%	11.32%	11.70%

1 John Smith		Equity	Shares	Base										
Year	Cal Year	Award	Granted	Value	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	12/31/2020	12/31/2021	12/31/2022	12/31/2023	12/31/2024
1	2015	1.00%	1,000	25,000	8,250	19,223	33,816	48,520	66,900	89,875	107,106	126,922	149,710	175,917
2	2016	1.00%	1,000	33,250		10,973	25,566	40,270	58,650	81,625	98,856	118,672	141,460	167,667
3	2017	1.00%	1,000	44,223			14,593	29,297	47,677	70,652	87,884	107,699	130,488	156,694
4	2018	1.00%	1,000	58,816				14,704	33,084	56,059	73,290	93,106	115,894	142,101
5	2019	1.00%	1,000	73,520					18,380	41,355	58,586	78,402	101,190	127,397
6	2020	0.00%	0	0						0	0	0	0	0
7	2021	0.00%	0	0							0	0	0	0
8	2022	0.00%	0	0								0	0	0
9	2023	0.00%	0	0									0	0
10	2024	0.00%	0	0										0
		5.00%	5,000		8,250	30,195	73,975	132,791	224,691	339,566	425,722	524,802	638,743	769,776
					0.25%	0.68%	1.26%	1.81%	2.44%	2.96%	3.22%	3.45%	3.66%	3.83%

Summary | Valuation Method | Participant Awards | Participant Values | Vesting | Cash Flow | Variables | Calcs | Rat

As you can see, the modeler tackles terabytes of data, creates formulas on all fronts and presents it in a way that you are fully informed in real time as you decide next steps.

Taxes and Captive Insurance

Many companies use captive insurance companies in concert with the phantom plan because they can deduct tax payments today when funding and receive capital gains treatment at pay out.

In this design, your company sets up a captive insurance company allowing the same group of employees participating in the phantom plan to hold ownership in the captive insurance company, too. The company pre-funds insurance, on a tax-deductible basis, tied to the employee's retention. At the time of distribution of the phantom shares, the employee receives the value of the phantom shares, minus his equity in the pre-funded captive insurance company. We can offer much more insight on this concept beyond the scope of this paper.

Turning now to accounting issues.

Accounting Issues

Phantom stock plans settled in cash generally require variable accounting, which requires on-going interim calculations of the related compensation expense. The company should accrue the estimated compensation expense over the period during which the awards are earned.

Equally important, you must adjust company financials each year to account for any added share awards earned by an employee-participant, and account for any increase or decrease in share price value.

Note that in variable award stock options, a charge amortizes only over a vesting period. But with phantom stock or SARS settled in cash (stock appreciation rights), the charge accrues during the vesting period. Once vesting occurs, all share price increases are taken as they occur.

Other Issues

ERISA: It is important to consider the ERISA implications of plan design. If a plan is designed to defer compensation until retirement, ERISA may apply - subject to the "Top Hat" exemption for unfunded plans for a select group of management or highly compensated employees.

Securities Laws: Even though no company shares will be issued in conjunction with most phantom stock plans, the plan may be considered an offer to sell securities under federal securities laws. However, there are exemptions in such rules for privately-held companies that may apply.

Applicability for S Corporations and LLCs: Phantom stock plans work well for both S Corporations and LLCs. They can be designed on either a full value or an appreciation basis, and can be tailored to meet the specific needs of the participants in a manner consistent with the sponsoring entity's goals and objectives. Note, for LLCs, phantom plans are generally referred to as phantom unit plans and can be structured to mirror a capital interest, a future profits interest, or both.

Finally, some S Corporations and LLCs use a performance units structure rather than a phantom stock format when it is more appropriate to tie the participants' long-term compensation to specific performance criteria versus share price, where it is desirable to use different performance criteria for different key employees, or to incorporate strategic as well as financial goals. Significant flexibility exists. For example, performance unit value could be based on incremental revenue for the sales team, and a combination of revenue and operating income for others. In addition, the unit value could include an opportunity cost of capital factor.

Financial Matrices

EBS builds models and selected financial matrices around your plan design. As an example, when designing a Performance Phantom Plan, you may choose to use two or more financial matrices to value units awarded to employees. As we discussed earlier, the units will be converted to cash payments at a future date.

Our proprietary modeler will help communicate the value to the employee so he or she can see the impact on improving the targeted matrices. The modeler is important in the plan communication when grants are made at various prices over a number of years. It simplifies communications.

Funding the Plan

Phantom stock programs, as with nonqualified plans, do not require cash funding. Participants in the plan won't know in advance how much they will receive in benefits. The amount of their benefit will depend on their future performance, as well as that of the company sponsoring the plan.

Employees want the assurance that the company has enough money to pay the benefits they earn. Therefore, some companies do set aside dollars in anticipation of plan payment obligations.

Reasons for informal funding:

> **To provide a degree of benefit security to participants;**

> **To match plan liabilities with a pool of assets; and**

> **To reduce plan cost through tax-advantaged pre-funding.**

Usually, companies set up sinking funds—another asset on their balance sheet for cash to pay benefits. Typically they use corporate-owned life insurance (COLI) which can also provide benefits in the event of early death of the employee, as well as cash values used for benefit payments. Companies can also use mutual funds and other assets. As mentioned above, the application of captive insurance strategies also brings unique tax benefits to both the company and participants.

Securing Your Plan

If funds are set aside, you can move out from under the regulatory clouds by segregating stock funds into a Rabbi Trust or a captive insurance company. This action enables employees to pay tax on the benefit when it is promised, not when it is paid. You have a fiduciary obligation to protect your select group's phantom stock; it may be the only way to fill the upcoming retirement gap.

At the centerpiece of a Rabbi Trust is the employer-owner's commitment to place investments in the trust and to earmark these investments to fund obligations under the plan. A frequent issue in phantom stock plans arises over how does the employer-owner informally fund his or her promise to pay plan benefits.

The essential tension in nonqualified plan design lies between the need to maintain the plan as unfunded (so that benefits are not currently taxable and the plan is not subject to most of Title I of ERISA), but still secures employee benefits.

The most common solution to this dilemma is a Rabbi Trust, which is an irrevocable, employer-established grantor trust set-up by the company to hold assets, separate from the other company assets, for purposes of paying future participant benefit obligations.

The Rabbi Trust protects participants from financial events caused by change in control or change in heart of the employer. However, in order for the phantom stock plan and the participant accounts to maintain the tax-deferred status, the assets of the Rabbi Trust are available to general creditors of the company in the event of the company's insolvency, which means they are subject to the claims of the company creditors.

Is It Right For You?

By now, you may be interested in setting up your own phantom stock plan. No doubt, you're also asking yourself how you set aside these funds given all the other demands on cash flow. EBS will assist you to model key assumptions using its Phantom Stock Modeler, as well as run various scenarios of plan liabilities, benefits, and future cash flow needs. Visit www.executivebenefitsolutions.com and run some of the models yourself, or call us, and we will be happy to walk you through a few examples.

Documentation, Implementation and Communication

At this stage, you're ready to convert the concept of your plan design and strategic decisions into the appropriate documentation. Normally, phantom plans require three documents: a formal plan document, an employee plan agreement, and an employee plan summary.

Of note, five main areas of administration demand focus of the employer-plan sponsor. Finance, accounting, human resources and legal typically handle their respective responsibilities, but administration should be coordinated across departments for accuracy of data and consistency of execution. The company may handle all these functions internally or seek the help of an experienced third-party administrator. EBS delivers the resources needed for coordination, including a dedicated account team to assure your plan runs smoothly.

Your Takeaway Message

A phantom stock option plan built to align with your corporate objectives, secured by a Rabbi Trust, and put on steroids with a captive insurance strategy becomes the exquisite secret to bring a smile to your face. You see, you can have it all.

When all the analysis is complete, phantom stock plans become the energy pulse needed to incentivize and transform your key employees to think and act as owners and shareholders.

No longer feel like a lone wolf on a quest. Now you can rely on select employees to help you shoulder the heavy responsibilities of corporate growth. And you gain the best of both worlds: Empowered employees and a lock on your stock.

Of course, one long-term incentive does not guarantee this goal alone. We presume you've done the hard work of building the foundation for a get-it-done culture full of integrated teams and cross-department champions.

Among the key decisions before the move to a phantom stock plan is the careful determination of a value formula for the stock and the amounts to issue. Any fees invested in professional help will be well spent.

Finally, with the proper funding strategy in place—sinking fund or captive insurance—your customized phantom stock plan functions as an auxiliary power unit to future cash flow. Best of all, your decision to proceed will add meaningful value to the work lives and retirement of select employees who've made, or are making, all the difference in your company's success.

In the uncertain years ahead, companies will need every talented employee possible to fill the growing management void and that means a powerful benefits magnet to attract, retain, and reward them.

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