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# Realities of Phantom Stock and SAR's (Stock Appreciation Rights)

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In recent years, many of my clients have asked me to assist them in creating "synthetic equity" plans for their companies. They offer these incentives in lieu of more traditional employee ownership structures, such as stock options, restricted stock or other "real" equity incentives. In other words, the owners want to share the upside or growth in the business with employees without sharing true ownership.

In a corporation, we typically refer to these arrangements as phantom *stock* or *stock* appreciation rights plans. In a limited liability company or partnership, we refer to them as phantom unit or equity appreciation rights plans. In either case, the idea is that the company creates a non-qualified deferred compensation arrangement that pays an amount to the participants based upon the value of the company if there is a triggering event under the plan. These plans are especially effective in compensating the company's management team or a group of key employees.

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**Phantom Stock** is simply a promise to pay a bonus in the future in the form of the equivalent of either the value of the company's shares or the increase in value over time. The value may be determined by appraisal or could be set by a formula consistently applied from year-to-year. For example, let's say ABC Corporation wants to establish a phantom stock plan for its key managers. It may set aside 10% of the equity value of the company in the form of 100,000 phantom stock units. If ABC grants Bob 10,000 units, Bob does not have to pay income tax on the grant until he actually receives a payment from ABC (assuming certain tax and other plan requirements are met). If ABC is later sold for $25,000,000 (assume after expenses and commissions), Bob would be entitled to receive a payment of $250,000. The payment would be treated as compensation income to Bob, subject to ordinary income tax, employment taxes and other potential offsets. If Bob left ABC before the sale, he may or may not be entitled to participate in the sales proceeds, depending upon the provisions in the plan. Moreover, the plan could provide for a payment to Bob upon separation from service with ABC (i.e., termination of employment or death), based upon the appraised value of ABC or some other permissible formula under the plan documents.

**SARs** are very similar to phantom stock, except that they allow participants to receive the cash equivalent of the increase in value of a specified number of shares over time. Using the example above, assume ABC grants Bob 10,000 SARs, which equate to 10,000 shares of ABC common stock, when the value per share is $1.00. If ABC is sold at a net price of $10.00 per share, Bob would be entitled to a cash payment of $90,000 ([$10-$1] * 10,000) under the plan. Like phantom stock, the SAR payments are treated as compensation income, subject to ordinary tax and withholdings. Sometimes, companies give the participants the right to receive actual shares of company stock when a SAR is exercised, although I am seeing fewer plans structured with this "real equity" feature.

The company claims a **tax deduction** when the payments are made to the plan participants, and the participants generally recognize ordinary income when the payments are received. Note: Plan drafters need to be careful not to violate tax rules under Section 409A, which may cover phantom stock and SAR arrangements. If this section is violated, the recipient must pay tax at the time of the grant of the phantom stock or SARs (not when the payment is received in a later year) plus an excise tax of 20%.

For **financial reporting purposes**, the company records compensation expense on its income statement as the employee's interest in the award increases.  In the year of grant, the company expenses the value of the award received, even though the award may be subject to vesting restrictions.  In each year, the value and expense is adjusted to reflect the additional pro-rata share of the award the employee has earned, plus or minus any adjustments to value arising from the rise of fall in share price.  Accounting treatment becomes more complicated if vesting occurs gradually over time or based upon performance, or if the award is settled in company shares.

Finally, to avoid the constraints and requirements of the **Employee Retirement Income Security Act** of 1974 (ERISA), you should design your plan to benefit a limited number of employees or to pay annual bonuses to a broader group of employees based upon a measure of equity.  You also may need to consider federal and state**securities laws** before implementing a phantom stock or SAR plan.

Phantom stock and SAR plans serve as wonderful incentives to compensate key employees over the long-term. They also can be traps for the unwary, when it comes to tax and regulatory compliance, so using boilerplate plans from the Internet or inexperienced counsel could prove to be a fatal mistake.  Please consult with an experienced tax attorney before undertaking the creation or modification of these arrangements.