Beware of the phantom...equity

Benjamin D. Panter | Monday, October 31, 2016

Offering equity incentives can help companies to recruit talent and provide employees with a stake in the company's success. Providing employees with an actual ownership stake, however, carries risk because employees that hold actual equity in a company typically have the rights of an owner. Phantom equity plans can mitigate these risks because phantom equity does not represent an actual ownership stake in a company. Rather, phantom equity represents the right to receive certain payments based upon the value of the company that "tracks" an equity interest in the company. As a result, phantom equity programs have become increasingly popular, particularly among closely held and emerging growth companies. While phantom equity programs have obvious value, they present traps for the unwary that may undermine their success. While each phantom equity program is unique, it is common for companies to overlook the following items when designing their phantom equity program.

Available Cash and Liquidity Considerations

Most phantom equity programs are structured to tie the payout to an event when the company will have an influx of cash, usually a sale transaction (sometimes called a "liquidity event"). Many programs, however, neglect that an event that triggers payout under the program may not necessarily be a liquidity event where cash is available to settle the phantom equity awards. In other words, because a phantom equity program typically requires a cash payment upon the occurrence of a specified event, to the extent the company does not receive (or have) cash at the time of the triggering event, the company may have a cash outlay without a corresponding cash inflow. This may not only create financial hardship for the company but could also undermine the ability of owners to sell the company.

For example, if a company is sold for stock of the buyer (e.g., a stock-for-stock transaction), neither the company nor its owners will receive any cash in the transaction. Nonetheless, because the phantom equity program requires payout upon the occurrence of a sale transaction, employees may be entitled to a cash payment in settlement of their phantom awards, even though the transaction does not involve cash. Moreover, if a company raises capital in a transaction that meets the definition of a “sale event” under the phantom equity program, employees may be entitled to a cash payment because the triggering event has occurred, even though a sale event has not occurred. As a further illustration, assume an emerging growth company is owned by a group of founders that raise capital by selling a 51 percent stake in their company. If the phantom equity program trigger is a greater than 50 percent sale, then the company may have to pay employees cash in respect of their phantom awards, even though the company has not undergone a liquidity event. This scenario can be particularly troubling because the purpose of a capital raise is often to raise cash to grow the business, rather than make cash bonus payments.

Valuation Considerations

Many private companies struggle with the most effective manner to value their companies. In the phantom equity context, valuation can create significant obstacles to an effective program. First, if the program is structured as an appreciation award (an award structured to provide value based upon an increase in a specified stake in the company), the company must determine the base value against which it will measure value creation. Second, if the program is designed to be settled upon an event other than a true sale of the company, then the company must determine how it will value the company at that time. Specifically, some companies use a specified date upon which to settle phantom equity awards rather than a liquidity event, particularly if the company has an owner base that is unlikely to sell (e.g., a family held business). For example, assume a phantom equity program provides that an employee will receive payment of phantom equity upon the earlier to occur of a sale transaction and a date that is seven years following the date of grant. If no sale transaction has occurred by the seventh anniversary, the company will have to pay the employee under the phantom award on that date. In order to make this payment, the company will have to determine the value of the underlying equity, which may require paying for an independent valuation. While the cost of an independent valuation may be palatable on a one-off basis, a company that has a broad-based phantom equity program should consider the financial and administrative costs of conducting multiple valuations for awards that must be settled on multiple dates. In other words, if a phantom award must be settled on a stated anniversary of the grant date and there are multiple grant dates, the company may have to obtain a new valuation on each anniversary date. Further, if the phantom equity is settled on a specified date, the company may have cash flow issues because the company will have to make a cash payment even though no liquidity event has occurred.

Tax Treatment of Phantom Equity

By contrast to an actual equity grant which may be eligible for capital gains treatment upon sale, phantom equity will be taxed at ordinary income rates. As a result, a phantom equity program generally delivers less net economic value than an actual equity program, assuming the same grant size.

Tax example: In year 1, Employee is granted 100 phantom shares in Company when 100 actual shares

> of the Company are worth $100. Under the phantom share award, Employee will be entitled to payment in respect to the phantom shares upon a sale of Company. Company is sold in year 5 in a transaction where 100 actual shares of the Company are worth $500. From a tax perspective, Employee is not subject to regular income tax upon grant. Upon the sale of the Company in year 5, Employee will be subject to ordinary income tax on the $500 payout.

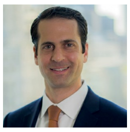
Further, phantom equity programs raise tax issues if the time and form of payout are not structured properly. Specifically, a tax code provision (Section 409A) limits the timing when a payment may be made under a phantom equity program. While the specific mechanics of Section 409A are outside the scope of this article, the failure to comply with Section 409A could result in a 20% excise tax imposed on the employee, which is in addition to regular income tax.

> **409A example:** Assume the same facts as the example above, except that the phantom program is not structured to comply with Section 409A. Employee will be subject to ordinary income tax on the $500 payment plus the 409A excise tax. If Employee’s ordinary tax rate is 40 percent Employee will pay $200 of regular income tax and $100 in excise taxes. Under this scenario, Employee will net only $200 ($500 payment less $300 of ordinary income and excise taxes).

Conclusion

Companies must be mindful of the various issues presented by a phantom equity program. If properly implemented, these programs can be an incredibly effective tool to align employees with the company’s owners, while simultaneously creating a mechanism to attract and retain talent. While a company may have a “scare” when initially being faced with the phantom (equity), with the right process and counsel, a phantom equity program can be a significant benefit for both companies and employees.

Looking to attract, retain, and motivate new talent? Click here to learn more about how equity-based compensation can create effective and strategic possibilities for small businesses.



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