PHANTOM STOCK PLANS (PSPs)

#FP*INSIGHTS*

A critical element in the success of any small business is its ability to recruit, reward, and retain talented advisors and support staff. To this end, equity is often used in addition to, or in conjunction with, compensation to achieve these goals. Synthetic equity is a special set of tools that can provide ownership-level benefits without buying or selling actual stock in an advisory business. A Phantom Stock Plan (PSP) is one of the most common forms of synthetic equity used to align key employees with a business's vision and growth plan.

WHAT IS A PHANTOM STOCK?

A Phantom Stock Plan, or PSP, is a long-term bonus plan that provides one or more key employees an award that is measured by the value of the employer's stock. However, unlike actual stock, the award does not confer equity ownership in the advisory business—there is no actual stock transferred to the key employee(s) in most cases. Instead, an employee is granted units of phantom stock that mimic the advisory business's actual stock in value and, perhaps, profitability but without a voice in governance and without the key employee(s) taking on personal debt to acquire the benefits.

HOW DOES IT WORK?

A Phantom Stock Plan is customized to fit each advisor's fact pattern and goals. A Phantom Stock Plan is one of two primary documents that is drafted. The other document needed is a Phantom Stock Award that provides for a specific number of units to be granted initially, and perhaps any additional units to be granted in the future upon certain goals being obtained. The number of phantom shares granted to a key employee depends on that person's perceived value to the business. The more an employee is valued, the more shares of phantom stock he or she is likely to receive; different employees could receive different amounts.

WHO CAN USE THIS TOOL?

Any independent financial advisor (RR, RIA or IAR, or those with insurance licensure) can use a PSP, provided that an entity is approved for use in a professional and compliant manner. While an S-Corporation or a C-Corporation are ideal, an FP Transitions' PSP can also utilize any type of LLC entity structure as well. PSPs are best used in a fee-based structure, or where recurring revenue makes up 70% or more of the annual revenue stream.

WHICH EMPLOYEES SHOULD BE CONSIDERED FOR PARTICIPATION IN AN PSP?

A PSP is a good solution for employees who are well paid in terms of base and bonus compensation, who are highly valued, and who are near an owner/partner level of performance. Examples include lead advisors and C-level officers. A PSP can also be used as a retention strategy for key employees since benefits are paid out in the future and may be contingent upon the key employee remaining employed or the achievement of performance goals.

WHAT PROBLEMS CAN BE SOLVED USING A PSP?

A PSP is often used in these situations: (a) a key employee wants to receive ownership-like returns but is either not ready for ownership, or is unable, or unwilling, to take on the financial risk of actually buying and paying for equity in the business; (b) an owner wants to share the economic value of equity but not equity itself, or doesn't want to provide seller financing to support such a transaction, or; (c) to provide a key employee with a right to share in a graduated percentage of business value. For instance, an employee might be granted the initial right to 5% of the business's value with the opportunity to earn an additional 1% for every $1 million in business value growth up to a maximum of 10% over the next ten years. Phantom stock may also include a share of ongoing profit distributions.

HOW IS A UNIT OF PHANTOM STOCK VALUED?

As a general rule, one share of phantom stock is equal in value to one share of actual stock in a given advisory business. Phantom stock follows the price of the underlying stock of the advisory business, a price that is commonly set and tracked by use of a formal valuation or appraisal. There is no single, locked-in value from start to finish—value fluctuates with the growth and success of the business.

WHAT TYPE OF PLAN IS THIS?

There are three main types of synthetic equity plans. 1) **Appreciation only plans** are commonly designed to pay out the value of any increase in the underlying stock value over a certain period of time from the date of the grant. 2) **Full value plans** are designed to pay both the value of the underlying equity as well as any appreciation that is earned over a set period of time and can result in a much higher payout to an employee. 3) **Performance unit plans** often exchange the use of equity as the measure of value for another metric such as growth in revenue or profitability to achieve similar objectives. An FP Transitions-prepared Phantom Stock Plan is usually set up as a **full value plan**.

IS A VESTING SCHEDULE USED?

Yes, in many cases. The recipient of the PSP benefits often has to wait—usually for a predetermined period of time or until the achievement of a set goal—which, if it does not transpire or come to pass, results in a forfeiture of some or all of the benefit.

HOW DOES A KEY EMPLOYEE RECEIVE VALUE FROM A PSP?

A participating employee will receive his or her payment like any other cash bonus. Actual payment of the PSP benefits is usually deferred until a predetermined date or until the employment relationship is formally terminated due to retirement, death, or disability. The PSP must specify when the phantom stock payments will start, and the point at which a valuation of the units is generally triggered. The PSP can provide for payment of the benefit(s) to be made in a lump sum or in installments over a period of years, or even in shares of actual stock.

HOW ARE THE BENEFITS OF A PHANTOM STOCK PLAN TREATED FOR INCOME TAX PURPOSES?

Whether paid in stock or cash, the payment is taxed as ordinary income at the time the payment is received and is deductible to the employer. Employment taxes are due at the time of vesting. FP Transitions' PSPs are deferred-compensation plans and, as such, must be designed and documented to conform to the requirements of section 409A (IRC). Accordingly, for income tax purposes, the deferred compensation attributable to the PSP will not be subject to income taxation to the key employee until it is actually paid to, and received by, the employee.

WHAT IS THE COST TO SET UP A PSP?

The long answer is that it depends on the number of people that you would like to provide PSP benefits to and the period of time the benefits are to accrue. The short answer is that a basic FP Transitions-prepared Phantom Stock Plan has a starting, flat-fee cost of $5,000 associated with the planning, drafting, and implementation work for the plan, not including the business valuation.

WHAT TEAMS AND SKILLS AT FP TRANSITIONS ARE INVOLVED IN THIS PROCESS?

FP Transitions' Legal Team will handle the drafting and implementation steps. The FP Transitions' Valuation Team can provide an industry-specific appraisal to accurately determine the underlying share value. On occasion, and when needed, support will be provided by the Consulting Team and the Analytics and Compensation Team as well to help determine eligibility, plan type, plan funding, grant points, performance time periods, and vesting schedule.

For more information, including benefits, detriments, and caveats associated with a PSP, be sure to read our white paper, Synthetic Equity: An Innovative Approach to Compensation, which can be downloaded at fptransitions.com/syntheticequity.

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