



Exit Planning

NAVIGATOR

Exit Planning Strategies for the Entrepreneur



Issue 57

The Real Tax Advantages of a Phantom Stock Plan

In the last issue of **The Exit Planning Navigator®**, we discussed the advantages of using a Phantom Stock Plan to achieve the business owner's desire to motivate employees so that those employees work to increase the value of his or her company. Rather than awarding stock, a Phantom Stock Plan gives the employee something that is valued like stock, but is not stock. Instead the employee is awarded "Participation Units," valued just like shares of stock. Participation Units grow in value in proportion to real company stock, but are subject to vesting, forfeiture, and payment schedules. Finally, Phantom Stock Plans allow employees to reap the financial rewards of ownership without the attendant risk.

In addition to all of these advantages, Phantom Stock Plans also carry several significant tax advantages.

First, when the Key Employee accrues a benefit under the company's Phantom Stock Plan, the IRS does not recognize that accrual as taxable income to the employee until he or she actually receives the money. This tax liability is usually incurred when the employee leaves the company and is cashed out (to the extent that his or her Participation Units are vested).

Second, upon the employee's termination, if the Key Employee receives money or property from the Corporation under the terms of the Phantom Stock Plan, the Key Employee is taxed at ordinary income tax rates and the Corporation receives a tax deduction for the amount paid to the employee.

Contrast that to an award of "real" stock. If an employee receives actual shares of company stock (instead of Phantom Shares/Participation Units) the repurchase of that stock (upon the employee's departure) is a nondeductible transaction for the company. In that situation, the company must use as much as \$1.60 or \$1.70 of its pre-tax cash flow to pay for the repurchase, on an after-tax basis, of each dollar of the departed employee's "real" stock.

In addition to ordinary income tax treatment, the amount paid to the Key Employee will also be subject to FICA, FUTA and employment taxes. Keep in mind, however, that the social security portion of the FICA tax is only imposed up to the taxable wage base. (In 2004, the taxable wage base, beyond which no FICA taxes are assessed, is \$87,900.) If the Key Employee exceeds the taxable wage base during the year in which the Phantom Stock/Participation Units were accrued he will not be assessed a FICA tax for the year he receives the cash for those Units. Of course, there is no ceiling for the Medicare portion of the FICA tax, so amounts vested and paid are subject to that portion of the FICA tax. Careful planning on the part of your tax advisors can limit the impact of FICA taxes.

8820 Ladue Road
Suite 201
St. Louis, MO 63124

tel: (314) 725-9939
fax: (314) 725-9938

www.claytoncapitalpartners.com



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(continued)

Remember that the employee is not taxed while in the active employ of the company, (instead being only taxed when he receives the vested portion of the award after he leaves the company). This situation sets up the third advantage. Namely, should that employee leave before being vested, he or she has not paid any income tax with respect to accruals under the Phantom Stock Plan. Contrast this situation with the sale of stock to an employee, which requires the employee to initially purchase the stock with after-tax dollars.

We encourage you to use this article as a basis for a discussion with your advisors about how best to motivate your employees to increase the value of your company. As always, please consult with professional advisors to discuss with them your specific situation.

Subsequent issues of The Exit Planning Navigator® discuss all aspects of Exit Planning.

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