Phantom Equity Plan
protect your legacy
Phantom Equity Plan – Design Considerations

In an effort to motivate and retain key employees, some privately-held employers create phantom equity plans where the employees are given many of the benefits of stock ownership without actually being given any stock in the company. Rather than receiving stock, the employees receive phantom stock that can be designed to track the price movement of the company’s stock value and pay out at a designated distribution event. Could a phantom equity plan be right for your company?

For the employer, phantom equity plans are advantageous in that no actual ownership is awarded, there are no minority holders, and it is in the employer’s hands to design terms and conditions from vesting terms to payment terms. Also, the employer gets a tax deduction when amounts are included in employee’s income. However, these equity plans do appear as a liability on the employer’s books.

For the employee, there is no tax event until a payment event and they have some skin in the game without putting up any money. However, since no stock is being purchased or issued, there is no actual ownership awarded, and the employee is taxed as ordinary income, not capital gains.

When designing a phantom equity plan, consider the following:

Who will be eligible?
- Decide which employee(s) will be selected to take part in the plan. Consider “Top Hat” (pension plans for select or highly-compensated employees) rules under ERISA.

What is the benefit?
- Benefits can be the value of the phantom share or the value of appreciation of the phantom share

How is the fair market value (FMV) of the benefit determined?
- FMV can be based on appraisal, based on formula, or based on good faith determination by the employer’s board

Does the employer want confidentiality/IP/non-compete/non-solicitation protections as condition to participate?

When will the benefit vest? Alternatives include:
- Only on a change in control (CIC)
- Upon achievement of performance goals
- Time-based vesting
- Termination without “cause”
- Termination for “good reason”
- Retirement
- Voluntary termination

Care must be taken in the design to ensure the desired tax results.

How will the benefit be paid?
- Lump sum?
- Installments?
- Will release of claims be required?

When will the benefit be paid?
- No later than March 15 of the following year of vesting event?
- Some other point in time?

Other considerations:
- Code Section 409
  Applies to compensation that workers earn in one year but that is paid in a future year and imposes significant tax penalties (e.g., an additional 20% tax) if the plan design does not comply
- Code Sections 280G/4999
  Golden parachute tax (of 20%) (and a loss of a corporate tax deduction) may be imposed if payments are considered excess parachute payments upon a change in control,
- DOL “Top Hat” statement filing generally required to be exempt from certain reporting and disclosure requirements

The Ice Miller Employee Benefits Group has experience helping employers establish and implement phantom equity programs. We have also assisted employers in complying with the tax and other legal requirements applicable to phantom equity plans and in communicating the plan to participants. For more information, contact Craig Burke at Craig.Burke@icemiller.com or 317-236-5881 or Marc Sciscoe at Marc.Sciscoe@icemiller.com or 317-236-2178.
<table>
<thead>
<tr>
<th></th>
<th>§ 422 ISO (Incentive Stock Options)</th>
<th>NQSO (Non-Qualified Stock Options)</th>
<th>Restricted Stock</th>
<th>SAR (Stock Appreciation Rights) or Phantom Stock</th>
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</thead>
<tbody>
<tr>
<td><strong>General Description</strong></td>
<td>Gives employee right to purchase stock for specified exercise price at future time; from employee’s perspective, has more favorable tax consequences than non-qualified stock option</td>
<td>Gives employee right to purchase stock for specified exercise price at future time; from employer’s perspective, has more favorable tax consequences than ISO</td>
<td>Transfer of stock to employee subject to a substantial risk of forfeiture</td>
<td>Obligates employer to pay employee an amount at some future time, based on the value of the employer’s stock at that time</td>
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<tr>
<td><strong>Who May Receive</strong></td>
<td>Employees Only</td>
<td>Employees, Board Members, Consultants, Other Service Providers</td>
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<td><strong>Exercise or Vesting Period</strong></td>
<td>Subject to applicable size limits, may be exercised immediately, but not more than 10 years after grant date; Many start-ups limit exercise until liquidity event</td>
<td>Not limited; Vesting typically occurs after passage of fixed period (time-vesting) or upon attainment of performance criteria (performance vesting); Many start-ups limit exercise until liquidity event</td>
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<td><strong>Limits on Size of Grant or Exercise Price</strong></td>
<td>Grants to an employee that first become exercisable in a year are limited to $100,000 (determined as of option grant date). Exercise price must be equal to or greater than FMV of the underlying stock on the date of grant.</td>
<td>No limits on size of grant, although plan will invariable contain such limits. Exercise price may be less than FMV of the underlying stock on the date of grant (discounted option), but discounted option must result in violation of Code Section 409A and/or additional accounting charge.</td>
<td>None</td>
<td>None. Unless grant is an SAR based on increases in value of underlying stock from the date of grant, grant will generally need to comply with Code Section 409A.</td>
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<td><strong>Tax on Grant or Exercise</strong></td>
<td>Subject to certain limitations, no tax on grant or exercise while an employee. The exercise of an ISO is not a preference item for AMT purposes.</td>
<td>No tax on grant. Tax on the spread between the exercise price and FMV at the time of exercise. Caution, may be subject to unanticipated taxes under Code Section 409A, unless exemption for employer stock rights applies under Treas.Regs. §1.409A-1(b)(5) applies.</td>
<td>If §83(b) election is made within 30 days of grant, then taxed at grant on the excess, if any, of the FMV over amount paid. If no election is made, then taxed at vesting on the excess, if any, of the FMV at that time over the amount paid.</td>
<td>No tax on grant. Tax on exercise as ordinary income (special FICA tax rules may apply). Caution, may be subject to unanticipated taxes under Code Section 409A, unless exemption for employer stock rights applies under Treas. Regs. §1.409A-1(b)(5) applies.</td>
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<tr>
<td><strong>Ordinary Income/ Capital Gains Tax</strong></td>
<td>If stock is held for one year after exercise and not sold until 2 years after grant, income on sale is taxed as capital gain (if sold prior to holding period, then ordinary income)</td>
<td>Ordinary income on exercise. Capital gains on sale of stock thereafter.</td>
<td>Ordinary income on FMV over purchase price at either (i) the time of §83(b) election or (ii) the date on which the stock becomes vested or transferable. Capital gains on sale of stock thereafter.</td>
<td>Ordinary income</td>
</tr>
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<td><strong>Tax Deduction to Company</strong></td>
<td>None (unless sold prior to holding period expiration upon which the Company will receive deduction on ordinary income recognized by employee).</td>
<td>Employer deduction upon exercise of option equal to ordinary income recognized by employee. Subject to reporting and withholding requirements (cash payment by Company even when employee receives only stock)</td>
<td>Employer deduction equal to amount of ordinary income recognized by employee</td>
<td>Employer deduction on exercise equal to amount of ordinary income recognized by employee</td>
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<td><strong>Securities Laws Issues</strong></td>
<td>Registration required unless there is an applicable exemption. Most common exemption is Rule 701 under the 33 Securities Act</td>
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<td>Registration may be required</td>
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<td><strong>Transfer Restrictions</strong></td>
<td>All shares of stock, once issued to the employee (whether under an option plan or a restricted stock plan), may be subject to transfer restrictions such as granting the Company rights of first refusal on any proposed transfer, and providing the Company redemption rights upon a termination of employment.</td>
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<td><strong>Documentation and Approval Matters</strong></td>
<td>To implement an equity-based compensation plan, the Board of Directors adopts a written plan, typically administered by the Board of Directors or compensation committee. The Board of Directors or compensation committee approves individual grants of stock options, restricted stock, SARs, or phantom stock. If the Company intends to grant incentive stock options, the plan must be approved by shareholders.</td>
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