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Family Business

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Phantom stock

Retain key execs without sacrificing ownership

Retaining key managers is essential to a company's long-term success, yet doing so can be an enormous challenge. As a result, businesses often use annual bonuses as well as competitive compensation and benefits packages to entice managers to stay. But for top-notch executives, this may work for only a little while.

Long-term solutions, such as stock options, give executives financial and emotional involvement in the company, providing these employees with more reasons to stick around. But what options do family businesses have when they want to keep their star nonfamily talent *and* hold on to full ownership of the company? Phantom stock may be just the answer.

AN INNOVATIVE SOLUTION

As you begin to appoint trusted and experienced nonfamily employees to high-ranking posts or retain loyal nonfamily managers, these workers may naturally expect to share in the profits and have more say in higher level decisions. But, like many family business owners, you may not want to relinquish company ownership to nonfamily executives. This can be for any number of reasons, including:

- An emotional need to keep ownership in the family,
- Conflicting business goals or management styles among family and nonfamily owners and employees, and
- Complex issues involved with having minority stockholders — for instance, dealing with nonfamily owners/employees when they leave the business.

In these instances, phantom stock — which is a cash incentive plan that resembles basic equity interests — can help. It can significantly compensate nonfamily executives for their financial performance and satisfy their desire to be included in the company's profits and growth while allowing family owners to retain actual ownership.

LONG-TERM MOTIVATION

Under a phantom stock plan, you would grant a certain amount of stock units to your key nonfamily executives; each unit equals the value of a current share of your company's common stock. There are a number of approaches you can take, including:

The stock approach. The phantom share could be given the same economic value as if the employee were given an actual share of company stock. If the stock's value never increases between the grant date and the date the phantom shares are "redeemed" by the company, the employee would receive a payment equal to the value of one share of stock of the company.

The stock-appreciation-right approach. The phantom share provided to the employee equals

the appreciation in the stock's value between the date the employee was credited with the phantom stock and the date the benefit is paid. So, as the value of the stock grows, so does the value of the phantom stock.

Payment of phantom stock usually occurs upon termination of employment as a result of retirement, death or disability. Redemption of phantom shares generally is based either on a fair valuation of the company or a formula, and the benefit is paid out in cash.

FLEXIBLE TERMS FOR VESTING

There are different ways you can structure the granting of phantom shares. One is to create a schedule providing for a certain number of phantom shares to be granted each year for a certain term (such as 10 years), with immediate vesting once phantom shares are granted. A twist on this approach is to grant a certain number of phantom shares each year unvested and provide that the shares vest after a certain term, such as five to 10 years or upon retirement after a certain age.

Another option is for the employer to grant shares to the employee periodically at its discretion without a predetermined schedule but according to the employee's performance each year. However, this method is less common because it typically doesn't provide the employee with any degree of certainty or security that his or her efforts will be rewarded, and may not have the "golden handcuff" effect that most employers are seeking when establishing these plans.

TRIGGERING EVENTS

Irrespective of the method selected, the phantom shares to be granted to an employee should be vested over a term of years. Typically, if an employer chooses a term-vesting plan or vesting schedule, the employee's phantom shares are immediately vested under certain circumstances, including a change in control (such as the sale of the business), or an employee's death or disability.

You may even include employment restrictions. If the stock is subject to forfeiture restrictions (such as vesting requirements based on an employee serving a certain number of years) and an employee is fired for cause — for instance, engaging in illegal or harmful conduct during the scope of employment — or resigns before the end of his or her contract, all of the employee's phantom shares can be forfeited without payment.

POTENTIAL DRAWBACKS

One potential drawback is the financial accounting that's required when administering a phantom stock plan. For instance, the value of the phantom stock must be expensed on the books at the time it's credited and adjusted at least annually to reflect its change in value.

You'll likely have to charge the obligation against earnings for the growth each year. Because the charge isn't a deductible expense, your financial statements may show a reduction in earnings with no corresponding deduction against taxes. This could create negative consequences, such as impeding your ability to secure a bank loan.

Phantom stock can significantly compensate nonfamily executives for their financial performance and satisfy their desire to be included in the company's profits and growth while allowing family owners to retain actual ownership.

Another potential drawback is that, as your key employees vest, you'll likely need to have cash available to pay the benefits. On the plus side, you'll receive a deduction when the plan pays out the benefits.

WEIGHING ITS WORTH

Are you prepared to invest in the retention of key nonfamily executives? A well-crafted phantom stock plan can benefit your business and star talent. It rewards them financially for their contributions to the company's success, making them feel part of your company, without diluting ownership — or control — of your family business. By providing this financial motivation, you may be able to keep these stars happy and loyal to your company for years to come.

When "I do" turns into "I don't"

Protecting your family business in the event of a divorce

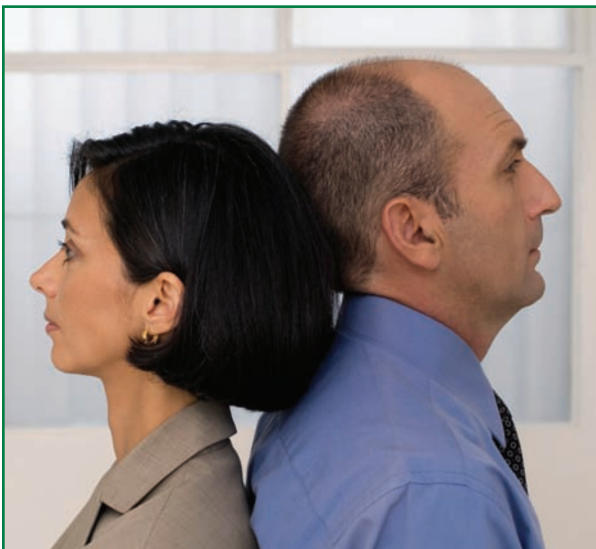
For anyone, divorce can be a challenge legally, financially and emotionally. But when the spouses are business partners, the legal, financial and emotional challenges are even more complex. Not only does the couple have to divide marital assets and settle support payments, but they must contend with business issues, such as dividing ownership and agreeing on the company's estimated value.

By considering how a divorce can affect your company, you can help protect your family business's future — and preserve your sanity — should "I do" turn into "I don't."

HOPE FOR THE BEST, PREPARE FOR THE WORST

In a divorce, a company is treated as an asset. So whether you and your spouse decide to divorce and walk away from the family business or continue on as partners, you'll need to plan carefully to protect both of your interests.

The last thing you want is for the courts to decide what the company is worth and, as community property (if applicable), how it should be divided.



Worse yet, the company could end up in the wrong hands, such as through a forced sale if neither you nor your spouse can buy the half interest.

The last thing you want is for the courts to decide what the company is worth and, as community property (if applicable), how it should be divided.

One solution is to decide these matters in advance. A buy-sell agreement, which can be in your written operating agreement or a separate standalone agreement, is one tool you can use. Specifically, buy-sell agreements can help by:

Determining who owns what. An agreement can prohibit the transfer of business ownership outside of the family by stipulating that, when a divorce occurs, the spouse not tied to the company must sell his or her stock to the ex-spouse or other remaining partners. It may also specify when the sale of interests to third parties is permissible.

Establishing value. Some of the most heated arguments during divorces involve the value of the family business. To minimize potential disagreements, outline the valuation method in the buy-sell agreement. If business ownership predates the marriage, you'll need to value the portion of the company that's considered marital property and subject to equitable distribution.

Settling business-related disputes. By outlining details pertaining to management transitions, the future sale of stock, advisory boards and other business matters, the buy-sell agreement

can offset contentious situations and conflicts among the owners.

DEAL WITH EMOTIONS

Don't get so bogged down with the business aspects of such a major life change that you don't deal with the emotional aspects. Divorce can be a major upheaval in one's personal and professional life, so give yourself time to grieve over your personal loss.

In addition, recognize and respect that staff members may lament their lost relationships with the departing spouse — especially if he or she worked in the family business. Also, reassure customers, investors and vendors that business will continue as usual.

MINIMIZE STRESS

It goes without saying that, when a relationship ends, both people involved fall under a tremendous amount of stress. Naturally, you can't eliminate this stress entirely but, at least when it comes to your family business, you can take steps to minimize it. The key is planning for the possibility of a divorce *before* it happens, because trying to react after the fact is much more difficult.

> 4 WAYS TO ACCENTUATE THE POSITIVE IN PUBLIC RELATIONS

Most companies encounter publicity at some point. Whether it's good or bad isn't as important as how well your family business handles it. Here are four ways to accentuate the positive — and minimize the negative — in your company's public relations:

1. Know your audience. Your audience is any group or individual who has an interest or stake in your company's activities. They include:

- Customers,
- Employees,
- Vendors and suppliers,
- Community members and organizations,
- Competitors,
- Government agencies, and
- Media outlets.

So keep your audience in mind and gear the information to them whenever sending out any internal or external company communications.

2. Put your best face forward. How do you want to be perceived by your audiences? As a pioneer in research? Community leader? Product innovator? Service champion? Knowing the answer to this question will help you prioritize the most important facts about your family business when developing communications or responding to negative publicity.

3. Have a public relations plan. Establish how you'll present your family business to stakeholders. Consider all avenues including internal and external communications and publications, public speaking, community outreach, service on advisory boards, and media outreach. In addition, designate who will be the spokesperson for your family business and on what matters he or she should — and shouldn't — comment. Having a spokesperson in place is essential so you can respond immediately to a crisis.

4. Have a crisis management plan. An unmanaged crisis could drive away customers and employees alike, cause sales to drop, or even make you a target for lawsuits. Your crisis plan should identify all the potential things — such as an unexpected death of an owner or key executive, a product recall, a layoff or employee misconduct — that could pose a crisis to your family business and ways to handle them.

Honey, I shrank the tax bill!

Implement these strategies by year end to save

Unfortunately, there's no super tax-shrinking machine that can disintegrate your tax bill or even zap it down in size. But there are several strategies you can implement before year end to significantly reduce it. And with new tax law changes in effect, you could have even more chances to say, "Honey, I shrank the tax bill!"

PERFORMING A BALANCING ACT

For family business owners, personal and business tax planning is often a balancing act. With businesses structured as a limited liability company (LLC) or S corporation, the income and deductions from these flow-through entities show up on the owners' individual tax returns. One misstep in business planning could negatively affect your personal or investment tax planning.

Let's say, for instance, that you're aiming to be below a certain adjusted gross income (AGI) threshold so you can qualify for a particular personal deduction. If you ship a large amount of merchandise or perform significant services for a customer immediately before year end, your plans could be thwarted.

Then again, if your family business operates on a cash basis, you can defer taxes by pushing income into next year and bringing expenses into this year. Thus, you could defer some of your billings until year end, as long as doing so doesn't jeopardize collecting payment. This enables you to be paid — and taxed — next year instead of this year.

REDUCING INCOME TAXES

For C corporations, a tried-and-true strategy has long been to pay out all net income by year end. If any profit is left in the corporation, it would be taxed at the corporate tax rate, and any distributions you take as dividends would be taxed, too — both at your individual and corporate tax rates.

Yet because dividend income is now taxed at a much lower rate (15%) than interest income (up to 35%), you should likely focus on moving away from taxable interest income to dividend income or, better yet, to tax-exempt interest.

Keep in mind that, when taking payment in the form of dividends, planning is essential to minimize the possibility that the IRS may suspect that the dividend payment is actually compensation. If the

> REDUCE YOUR AGI BY MINIMIZING LOSSES

When it comes to year end investment planning, focus on maximizing the tax benefits of capital losses. In general, avoid having long-term capital losses offset long-term capital gains — such losses are more valuable offsetting short-term capital gains.

You can deduct up to $3,000 of capital losses in excess of capital gains, which will reduce your adjusted gross income (AGI). So review your investment portfolio for opportunities to harvest capital losses and, if appropriate for your situation, adjust your investments more tax efficiently.

agency can prove its case, it may reclassify those dividends as wages and demand that you pay payroll taxes on them.

If you operate an S corporation or LLC, all of its items of income (losses, deductions and credits) pass through to you, the individual stockholder, and become part of your individual taxable income. If your business makes a profit at year end, you pay the income tax at the individual income tax level based on your percentage share of ownership in the company — whether or not you receive any cash distributions. If the business has a loss at year end, you realize this loss as a deduction against other income reported in this tax year.

If you project a loss at year end, consider putting more cash into the company to ensure there's sufficient basis to deduct the entire loss on this year's return. Why? As a corporate shareholder or LLC member, you can't deduct business losses that exceed your basis in your stock or loans in the corporation or your membership interest in the LLC. But with proper planning, you may be able to pass business losses through to your personal tax return and use them to offset highly taxed income from other sources.

MAXIMIZING TAX LAW CHANGES

If you've made, or plan to make, a major equipment purchase this year, find out whether it's eligible for Section 179 expensing. The Economic Stimulus Act of 2008 increased the Sec. 179 limit for initial year expensing to $250,000 (from $128,000). It allows a current deduction for newly acquired tangible personal property assets that otherwise would have been depreciated over a number of years.

The expensing election begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed $800,000 (up from $510,000 before the act). The new higher limits apply only for calendar year 2008 or a business's fiscal year that begins in 2008. As in the past, a business can claim the expensing election currently only to offset its net income, not to reduce net income below zero.

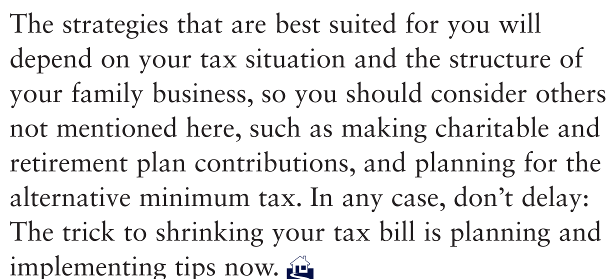
Another provision that you may qualify for is the bonus depreciation, which generally offers a special allowance for certain qualified property acquired and placed in service in 2008. And this is in addition to any property that qualifies for Sec. 179 expensing. For eligible property, the special depreciation amount is equal to 50% of its adjusted basis. Property that qualifies includes:

- Tangible property with a recovery period of 20 years or less,
- Computer software purchased by the business,
- Water utility property, and
- Qualified leasehold improvement property.

Be sure to review your expected year end profits before you deduct asset expenditures. That way, if your capital expenditures exceed your profits, you might be able to expense some of the capital assets placed in service during the year and depreciate the remainder, possibly creating a loss. You can then carry forward the loss to offset future expected income or carry it back to recover previously paid taxes.

ACTING NOW

The strategies that are best suited for you will depend on your tax situation and the structure of your family business, so you should consider others not mentioned here, such as making charitable and retirement plan contributions, and planning for the alternative minimum tax. In any case, don't delay: The trick to shrinking your tax bill is planning and implementing tips now.



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