

## Phantom Stock: The Substance Behind the Specter



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Companies seeking creative, cost-effective long-term incentives (LTIs) that preserve ownership are increasingly turning to phantom stock. After lingering in obscurity at public companies, the concept of phantom stock is quietly re-emerging among private firms. Despite its spooky name, phantom stock can, in the right circumstances, deliver the motivational power of real equity without the dilution, complexity, or governance tradeoffs that accompany traditional stock options.

### What Is Phantom Stock?

Phantom stock represents a company's promise to pay an executive a future cash amount tied to the value of its stock. It's an equity shadow which tracks share value over time without granting actual ownership or voting rights. Because it's a contractual right rather than real equity, taxation occurs at payout, and proceeds are treated as ordinary income, not capital gains. In short, phantom stock mirrors the economic benefits of ownership, without the ownership headaches.

### Designing an Effective Plan

Most phantom stock programs fall into two broad types:

1. **Appreciation-only plans** function like stock appreciation rights (SARs), rewarding only the increase in value since grant.
2. **Full-value plans** are similar to restricted stock units (RSUs), providing both the base and growth value.

Key design elements typically include:

- Eligibility and participant selection
- Vesting schedules and performance goals
- Valuation methodology and timing
- Settlement triggers
- Treatment upon termination or retirement
- Restrictive covenants or payment form

### Accounting, Tax, and Liquidity Considerations

Phantom stock awards are treated as liabilities for accounting purposes. The company must re-measure the expense at each reporting period. This can create earnings volatility, which can be a concern for many CFOs, especially if they are considering selling, or options for M&A or IPO. The tax deduction aligns with payout timing, and because awards are paid in cash, the company must plan for resulting liquidity needs. Additionally, phantom plans are subject to Section 409A of the Internal Revenue Code, which governs non-qualified deferred

compensation. Careful plan governance is essential—poor documentation or inconsistent valuation can quickly turn a motivational incentive into a compliance risk.

## Why Do Companies Use Phantom Stock?

Despite its complexities, phantom stock offers compelling advantages for both governance and performance alignment. Strategic benefits include no dilution, strong retention through vesting, design flexibility, ownership preservation, and alignment of executive and shareholder interests.

## Who Uses Phantom Stock?

Phantom stock tends to work best for closely held or family-owned firms that want to reward growth without diluting ownership, or for subsidiaries and business units that need to mirror enterprise-level incentives.

Although phantom stock is most common in private companies, it is also appearing in public company subsidiaries and business units where leadership alignment is crucial but equity issuance is impractical. Far from a passing trend, cash-based LTIs like phantom stock have earned a permanent place in the executive compensation toolkit.

## The Pros and Cons of Phantom Stock

Advantages	Disadvantages
Aligns rewards with company growth	Potential strain on company cash flow
No dilution of voting rights	Ordinary income taxation
Strong retention through vesting	Requires periodic valuation for private firms
Flexible design for units or divisions	Liability accounting introduces volatility
No tax until payout	Must comply with Section 409A
Can serve as deferred compensation	May affect valuation in M&A

## Phantom Stock May Sound Mysterious, but It’s Far from Spooky

Companies seeking the motivational benefits of equity without the ownership complications should consider phantom stock as a smart, governance-friendly incentive. When structured thoughtfully, and with clear communication, sound valuation, and disciplined plan design, it can help bring your LTI strategy to life.

## About the Author

Dan Moynihan is a managing director with Pearl Meyer. He is focused on all areas of pay including executive compensation, broad-based rewards, incentive design, and sales compensation development. Dan works to clarify client compensation and human resource objectives to develop programs that maximize their resources and existing infrastructure. Dan has a passion for helping

emerging and growth companies (public and private) with the design and development of executive compensation programs to help drive attraction, motivation, and retention of key personnel. Dan advises boards and executive management at a number of public and privately held companies in global industrial, retail, consumer products, and financial services organizations. He also works closely with private equity firms and their portfolio companies on pre- and post-IPO related issues.

## About Pearl Meyer

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