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There's Nothing Phony About Using Phantom Equity to Compensate Employees

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When it comes to compensating an employee with a grant of equity, it is not a perfect world if you consider the impact of taxation. A perfect world when granting equity compensation from a tax perspective would include at least the following:

- At the grant date, and as the grant vests, the employee receives no taxable income or gain;
- Upon a change in control, the employee receives the full value of the equity granted (for example, there's no strike price or participation threshold subtracted from the proceeds);
- The proceeds received are taxed only upon a change in control, which is when the employer company is acquired, and the shareholders can cash out their equity for dollars;
- The entire payout is long-term capital gain to the employee; and
- The employer can deduct the entire amount of the payout to the employee.

This perfect tax world for equity compensation doesn't exist, but phantom equity can help alleviate the shortcomings of other forms of equity compensation. One of the biggest advantages of phantom equity is that it's flexible and can be customized to numerous situations. Also, it can be used as a standalone measure to reward employees or to supplement other equity grants.

To understand the benefits of phantom equity, it's helpful to summarize the other tools for providing equity compensation.

EQUITY GRANTS

First, equity grants — such as grants of stock in a corporation or units in a partnership — are taxable as ordinary income when the recipient is considered to become the owner of such equity. The employee is considered to be the owner for tax purposes when the equity vests, or in tax parlance, is "not subject to a substantial risk of forfeiture."[1] The amount of ordinary income is equal to the fair market value when the employee becomes the owner of the equity. At the point when the employee becomes the owner of the equity, it's as if the employer made a cash payment to the employee and the employee then purchased the equity.

Thus, like any purchase of stock or units, a subsequent sale of such equity is taxable as capital gain. The amount of the capital gain on the subsequent sale is measured by the appreciation from the time when the employee included the equity in ordinary income, which is the time when the employee is deemed to have purchased the equity. If the equity grant vests over time, then as each portion of the grant vests, such portion will be taxable as ordinary income to the recipient. Similarly, when the recipient later sells the equity, any appreciation measured from each of the respective vesting dates is taxable as capital gain.

If the stock appreciates from the grant date by the time it vests, the employee's ordinary income recognition will likewise be higher. To address this issue,

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[1] *See generally* §83. All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

the I.R.C. allows a recipient to elect under §83(b) to include the full fair market value of the grant on the grant date even though the employee will not own the equity until it vests, according to the vesting schedule.

On the employer side, as the employee recognizes ordinary income the employer is entitled to a corresponding deduction for the amount of such ordinary income, unless disallowed by another specific I.R.C. section such as §162(m) for public corporations paying more than $1 million in compensation or $280,000 for ''golden parachute payments,'' which are limited situations.[2] When the employee receives capital gain on a subsequent sale of the equity, the employer is not entitled to a deduction.

ISOs AND NSOs

Options to purchase equity are another equity compensation tool. A grant of options is taxable similar to the preceding rules for stock/unit grants only if the option has a readily ascertainable value and it doesn't qualify as an ''incentive stock option,'' or ''ISO,'' under §421.[3] In tax parlance, options that are not ISOs are referred to as ''nonstatutory stock options,'' or ''NSOs.''

NSOs rarely have an ascertainable value upon grant and therefore are generally taxable as ordinary income whenever the option is exercised, in an amount equal to the difference between the underlying equity's fair market value on the exercise date minus the strike or exercise price on the option.[4] Also, if the strike price is less than fair market value of the underlying stock, the IRS might be able to characterize the grant as a deferred compensation arrangement.

In the stock option world, ISOs are treated differently from NSOs. Specifically, stock acquired via an ISO can benefit from long-term capital gain rates when subsequently sold. However, ISOs have very particular rules, including that:

- The stock acquired through the exercise of an ISO can't be sold until one year after the anniversary of the option exercise and the two-year anniversary of the grant date;
- The strike price of the option must equal the fair market value of the underlying stock on the grant date; and
- Only C corporations can issue ISOs.

In practice, due to the nuances of intricate rules, which aren't aligned to the realities of the practical world, ISOs rarely achieve the intended goal of providing the benefit of capital gain taxation to an employee. For instance, when an ISO is exercised the spread, which is defined as the difference between the fair market value of the stock minus the strike price, is treated as an ''adjustment'' for alternative minimum tax purposes.[5] This typically means that the employee will owe alternative minimum tax at a 28% rate on the spread, and this in turn usually motivates the employee to pay for such tax by selling the stock even though the sale will be a disqualifying disposition, which in turn causes the employee to be taxed at ordinary income rates on the spread.

PARTNERSHIP PROFITS

Partnerships, including limited liability companies that are taxed as partnerships, can issue ''profits interests,'' which are like a hybrid of straight equity and options. The employee is entitled only to the appreciation in the value of the equity from the grant date.

When there is a subsequent change in control, the amounts payable to the employee are then calculated by tracking only the appreciation from the grant date of the profits interest. Generally, profits interest held for at least one year will qualify for long-term capital gain.[6] However, please note that the profits interests of private equity companies, real estate funds, investment partnerships, and venture capital companies are generally governed by §1061, which was added by the Tax Cuts and Jobs Act of 2017 (TCJA)[7] and, among other things, requires that the employee hold the profits interest for at least three years to receive long-term capital gain treatment.

PHANTOM EQUITY

The challenge remains of how to transfer the full value of equity — not just the appreciation from the grant date like a profits interest or an ISO — to an employee who wishes to recognize long-term capital gain treatment upon a change in control.

Phantom equity is not an actual grant of equity but is a contractual right to receive a payment, which is tied to the value of equity. So economically, it's similar, if not identical, to equity.

For instance, suppose an employer was going to issue one share of stock to an employee. The employer could replicate this arrangement with phantom equity via a phantom equity grant, promising to pay the value of one share to employee upon a change of control.

[2] *See* §83(h).

[3] *See also* §83(e)(3), §83(e)(4).

[4] *See* Rev. Rul. 78-185.

[5] *See* §56(b)(3).

[6] *See generally* Rev. Proc. 93-27, Rev. Proc. 2001-43.

[7] Pub. L. No. 115-97.

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Generally, a phantom equity grant can be structured so that it isn't taxable when granted and only taxable upon payout when a change in control occurs. The downside is that payouts for phantom equity are taxed as ordinary income to the recipient. However — and here's where it gets interesting — a phantom equity payment can be grossed up to lower the employee's effective tax rate to equal that of long-term capital gains.

Specifically, the top ordinary income rate is 37% for individuals[8] and the top capital gains rate for individuals is 20%.[9] Thus, the gross-up only needs to account for this 17% difference. As a result, the employee is happy because his or her after-tax position is equivalent to having received capital gain treatment, and he or she receives the full value of the equity, not just the appreciation as in an option or profits interest scenario.

Also, employers are entitled to deduct the total amount of the phantom equity payment, unlike other types of equity compensation. Since employers receive a deduction for the entire payout, they can be better off issuing phantom equity with this limited gross-up than straight equity or an option. The benefit of the deduction will depend on the rate at which the business profits are taxed. Business income of an LLC, partnership, or S corporation can be taxed as high as 37%, which weighs more in favor of using phantom equity.

On the other hand, C corporation earnings are taxed at 21%[10] (at least for the moment), but even modeling out a gross-up for employers at this lower rate comes very close to a break-even for the employer (see figure, below).[11] These two factors — the limited gross-up to effectuate long-term capital gains rates and the corresponding deduction by the employer for the entire payment — creates a planning opportunity that comes very close to the perfect world from a tax perspective for equity compensation.

Assumptions:	
Purchase Price	$1,000,000
Percentage owned by Employee	10.0%
Payout to Employee	$100,000
Employee Files "Individually" & Receives at Least $200k in other wages Corporate Tax Rate	21.0%
Fed Ordinary Income Tax Rate	37.0%
LT Cap Gains (+ 3.8% NIIT)	23.8%
Spread Differential	13.2%
Employee portion of Medicare	2.35%
Employer portion of Medicare	1.45%
Gross-Up	$25,639

Analysis of Recipient of Equity Award[1]				
Item	With Gross-Up			
	Employee		Company	
	Stock Pmt	PE Pmt	Stock Pmt	PE Pmt
Liquidation Pmt	$100,000	$100,000	($100,000)	($100,000)
Gross-Up Tax		$25,639		($25,639)
Capital Gains Tax	($23,800)			
Ordinary Income Tax		($46,486)		$26,384
Medicare Tax		($2,953)		($1,822)
After Tax	$76,200	$76,200	($100,000)	($101,077)
Difference		-		($1,077)
				−1.08%

[1] Analysis: Employee's payout is grossed up to equalize what he/she would receive after-tax, if taxed at long-term capital gains rates. As a result, Employee is indifferent to phantom equity with the gross-up. Company deducts full payment. For each $100,000 paid, the company at a 21% rate is effectively paying Employee an additional $1,077 or 1.08%.

Please note, capital gains attributable to equity compensation are also subject to the net investment income tax of 3.8%,[12] and ordinary income attributable to equity compensation is also subject to Medicare taxes of 1.45%[13] and Social Security taxes of 6.2%[14] on the first $147,000 for the year 2022. These taxes — net investment income, Social Security and Medicare taxes — are considered in the modeling in the figure, but for simplicity aren't included in the discussion on rate differential as they don't significantly impact the analysis.

One issue with phantom equity is that it can be considered a deferred compensation arrangement. If a payout will be made to an employee after the employee leaves the company, §409A could cause the

[8] §1(j)

[9] §1(h).

[10] §11(b).

[11] Break-even appears to occur when the effective tax rate on the employer's earnings is at least 22%.

[12] *See* §1411(c).

[13] Tax at the rate of 1.45% for "Hospital Insurance" (commonly referred to as "Medicare") is imposed on both employees and their employers. See generally §3101(b) for the tax imposed on the employee and §3111(b) for the tax imposed on the employer. Once the wages exceed $200,000 the employee's rate, if filing as an individual (or $250,000 for married filing jointly), is increased to 2.35%. See §3101(b)(2).

[14] Tax at the rate of 6.2% for "Old-Age, Survivors, and Disability Insurance" (commonly referred to as "Social Security") is imposed on both employees and their employers for wages paid up to the "contribution and benefit base" for a given year. See generally §3101(a) for the tax imposed on the employee and §3111(a) for the tax imposed on the employer. The "contribution and benefit base" is determined according to an automatic formula set forth in §230(b) of the Social Security Act (see 42 U.S.C. §430), which for 2022 is $147,000. In the figure it is assume that employee is making over $200,000 and therefore the receipt of a payment from phantom equity would not impact employee's Social Security taxes since employee's wage already exceed such base and employee would not have any addition Social Security taxes imposed on the phantom equity payout.

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employee to incur a 20% excise tax, in addition to recognizing ordinary income, and deny a deduction to the employer. However, a phantom equity grant could be structured to convert effectively into a stock appreciation right to exclude this treatment in the event that an employee leaves the company, and stock appreciation rights are not subject to §409A.[15]

Phantom equity can also be issued to supplement the issuance of an option, whether an ISO, NSO, or a profits interest. In this fashion, the phantom equity grant would help the employee receive full economic value of the stock or provide liquidity to the employee to pay tax upon the exercise of an option.

A non-tax disadvantage to a phantom equity grant is that the employee won't be an equity holder of the employer. However, for a minority shareholder the tax benefits of phantom equity can outweigh those of actual equity when ownership of such actual equity carries few if any meaningful rights.

[15] *See* Reg. §31.3121(v)(2)-1(b)(4)(ii).

CONCLUSION

If the goal of an equity grant is to provide an employee with the greatest economic benefit, phantom equity is a great tool. It can be used to supplement the grant of a profits interest or an option, which would otherwise only entitle the employee to the appreciation of the profits interest or option. Alternatively, on a stand-alone basis phantom equity can be more attractive than other equity arrangements where the employer's earning are taxed at an effective tax rate greater than 22%. This can be accomplished by grossing-up the employee's phantom equity payment to replicate the employee's after-tax position as if he or she was taxed at capital gains rates when receiving a phantom equity payment. When issuing a phantom equity grant with a full gross-up to mirror capital gains treatment to the employee, the employer will pay more out of pocket if its earnings are taxed at a rate below 22%. However, this excess payment can be modeled and the gross-up can be adjusted if desired so that employee and employer can share the additional cost borne by the employer.

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