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Stock Grants and Phantom Income

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This Kind of Corporate Benefit Your Employees Don't Welcome.

Stock Grants and Phantom Income

You own a small and very successful private company. You know that you would never have become so successful without the dedication and hard work of your trusted key managers. You have one particularly valuable manager who you would like to reward with some ownership of the company. He is a valued manager and has asked you before if you would consider giving him some equity. You decide that a 10% ownership of the common stock of the company would be in order, so you grant him shares equivalent to a 10% ownership while you maintain your 90% ownership. You know your manager will be very thankful. Next April your new co-owner comes to you and asks you how he's going to pay his federal and state taxes on the $300,000 in compensation income (the taxes for which could be as high as $90,000) that he has received when he has no cash to pay the taxes.

You have just saddled your valued manager with a tax burden that he or she cannot pay. You say to yourself: no good deed goes unpunished — how could this have happened? This is, unfortunately, an all too common occurrence. A version of what is known as "Phantom Income" —- taxable income with no accompanying cash to pay the tax. The employee cannot pay his taxes with stock in the company and otherwise has no cash to make the tax payment. There are many ways that businesses create Phantom Income and this is one of the most common. Boards and equity owners of small and medium-size companies wanting to reward their dedicated senior management with ownership often do not take into account the tax aspects of stock grants.

If your company gives an employee stock without requiring a payment from that employee, the employee has received a stock grant. When a taxpayer receives a grant of vested stock, in tax jargon: "stock that is not subject to a substantial risk of forfeiture," then that person has received compensation income for the year they receive it. The amount of the income is equal to the fair market value of the stock at the time they receive it, reduced by the amount they paid for it, if any. If the employee pays nothing for it, the entire fair market value of the stock is taxable to them as ordinary income. In addition, the employee must pay federal and state withholding and the employee's share of Social Security tax. If an executive receives a 10% ownership interest in a company that has a stockholder's equity at fair market value of $3,000,000, without discounts and deductions, the gross ordinary income could be as high as $300,000. That is hard to swallow when you are not receiving any additional cash to pay the taxes.

Rewarding valuable senior management with ownership of the company is a good instinct . But it does take some careful advance planning. If you're in a situation where the company has just become established and has not yet grown enough to warrant an ascertainable fair market value, this may be the time to distribute the benefits of equity to your management team. But many companies do not know who the key players will be at the beginning of corporate life. Often it is only much later that the company knows who it wants to reward and by that time the fair market value of the business could be substantial.

It is important to consult your company's tax lawyer or accountant before the company creates a plan to reward their employees with company stock. There are other alternatives to achieve the same objectives without subjecting the employees to Phantom Income or at least decrease the exposure to Phantom Income, alternatives such as stock options, cash bonuses, stock appreciation rights, profits interests in Limited Liability Companies and Partnerships, but each of these alternatives demands careful planning and have their own set of traps for the unwary.

When you think of rewarding your employees with ownership, consult your lawyers and accountants and make sure you are not giving them an unnecessary or unplanned tax burden along with a piece of the rock.