

Characteristics of SARs and Phantom Stock Rights - Comparison of Stock Options as a Performance Incentive Technique

by Stephen Fackler Partner Employee Benefits and Equity Compensation
Group Cooley Godward LLP

"Neither SARs nor Phantom Stock receive any preferential tax treatment, nor is there any deferral of the tax beyond the time of payment." (Based on presentation given at Foundation for Enterprise Development's Breakfast Workshop.)

This memorandum summarizes and contrasts the characteristics of stock appreciation rights ("SARs") and phantom stock or similar rights ("Phantom Stock") as performance incentive techniques. This memorandum summarizes and contrasts the characteristics of stock appreciation rights ("SARs") and phantom stock or similar rights ("Phantom Stock") as performance incentive techniques. First, a brief description of SARs and Phantom Stock is provided. The memorandum then compares SARs and Phantom Stock with more frequently used stock options, specifically with respect to: tax and financial effects on the recipient employee (the "Employee") and on the corporate employer (the "Company"); plan terms and flexibility; and various corporate accounting and securities law aspects. By in large the key elements of this discussion are equally relevant to non-employee recipients such as consultants and outside directors.

Basic Characteristics of SARs and Phantom Rights

SARs

SARs provide a method of paying Employees deferred bonus or incentive compensation that is measured by the appreciation in value of the Company's stock over a period of time. SARs are an unsecured promise by the Company to pay an amount to the Employee at some future date when the Employee exercises his or her right to receive the payment or the right expires. The amount paid at exercise or expiration is equal to the difference between the value of a specified number of shares of Company stock on a specified date, usually the date the SARs are granted, and the value of the stock on the date the SARs are exercised or expire. SAR payouts generally are made in cash, but they also may be paid in Company stock, or in a combination of cash and Company stock. SARs may be granted alone, or they may be granted in addition to stock options or in tandem with stock options.

SARs generally are effective for a fixed term of years, such as five or ten years from the date granted, but terminate sooner in the event of the Employee's termination of employment. Vesting conditions may be imposed such that the SAR is forfeited in whole or in part if the employee terminates employment prior to one or more designated vesting dates. Employees often may elect when to exercise their SARs, to the extent vested, and thereby have some control over the timing and, subject to fluctuations, the value at the time of exercise. If not exercised earlier, or if the SAR does not give the Employee the ability to choose the time of exercise, the value would be paid when the term of the SAR expires.

"Stock options provide continuing performance incentives through stock ownership after the exercise of the option, to the extent the Employee retains the shares and does not sell them immediately thereafter."

Phantom Stock and Similar Rights

Like SARs, Phantom Stock also is used to provide deferred or incentive bonus compensation to Employees and also involves an unsecured promise by the Company to pay an amount to an Employee at some future date. Typically, a share or unit of Phantom Stock is designed to equal either the actual fair market value of a share of Company common stock or an amount determined under an equity-based formula for valuing the stock, such as book value, value determined under a capitalized earnings formula, or a combination of these or other valuation approaches. Phantom Stock units may be awarded to Employees or "purchased" by Employees, including through salary reductions. Adjustments to Phantom Stock may be made to reflect any stock splits, stock dividends or other changes to the Company's common stock. In some cases, the value of Phantom Stock units is increased by any cash dividends paid on the Company's common stock.

Payments of Phantom Stock value are usually made at a pre-determined time, such as termination of employment, attainment by the Employee of a specified age or after a fixed term of years. The amount paid is either the full value of the Phantom Stock held by the Employee at the applicable valuation date or the full value as reduced by the value at the time the Phantom Stock rights were acquired by the Employee (e.g., where the Employee did not pay for the rights or the Company only desires to confer to the Employee the benefit of the Phantom Stock's appreciation).

Phantom Stock payments may be made in cash, Company stock, or in some combination thereof, although other forms of consideration also may be used. Phantom Stock plans vary widely, and imaginatively, in their terms, but typically contain requirements such as continued employment as a condition of payout.

"Performance units" or "performance shares" are terms often used to refer to variations on Phantom Stock in which Employees receive a right to future payment of an amount based upon the attainment of specified Company performance goals. Examples of performance goals include achieving a targeted level of earnings, net income, sales, return on equity or other desired benchmarks over a specified period, which might range from one year to five years. Each performance unit or share would have an assigned "par" or "target" value if the performance goals were met exactly and a scale for increasing the value (e.g., up to 150% or 200% of assigned par value) if the performance goals were exceeded by specified amounts. A reduced or zero value might apply according to a scale if performance falls below the performance goals. Payment of the value of performance units or shares typically would be made shortly after the end of the performance measurement period, but could be further delayed, if desired. Other than the method for measuring the amount to be paid out, performance units and performance shares generally have the same characteristics and effects as Phantom Stock. Consequently, the discussion of Phantom Stock in the remainder of this memorandum applies equally to performance units or performance shares.

Comparison of SARs and Phantom Stock to Stock Options

Effects on Employees

Cash Outlay

Employees generally do not make any out-of-pocket payments to acquire their rights with respect to a SAR or Phantom Stock, except in certain relatively unusual situations where Employees must "buy" Phantom Stock, without any cash outlay by the Employee. By contrast, although an Employee does not pay any amount when granted a stock option, the Employee must make a cash outlay in the amount of the option exercise price in order to acquire the stock and capture any potential appreciation in value.

Tax Treatment

A key difference between SARs, Phantom Stock and stock options is the tax treatment to the Employees. The payment made to an Employee from an SAR or under a Phantom Stock plan, whether paid in cash, stock or some other form of consideration, is taxable to the Employee as ordinary income at the time received. Neither SARs nor Phantom Stock receive any preferential tax treatment, nor is there any deferral of the tax beyond the time of payment.

The tax treatment of stock options under the federal income tax varies with whether the option is a statutory option (known as an "incentive stock option") or a nonstatutory option. A statutory option is not taxed at the time of grant or at the time of exercise of the option, although there is an alternative minimum tax adjustment item in the amount of any built-in gain at the time of exercise. A statutory option is taxed at the time the stock purchased upon exercise of the option is sold or otherwise disposed. Any gain on the sale of the stock at the time the stock is disposed is taxed at capital gain rates, if certain statutory holding period requirements are met. Thus, the tax effect of statutory stock options is preferential in that income is both deferred until the stock is disposed and then, if the holding periods have been satisfied, is taxed at capital gain rates.

A nonstatutory stock option is not taxed at grant, either. However, it is taxed at exercise. The difference between the option exercise price and the fair market value of the stock purchased upon exercise of the option is taxable to the Employee as ordinary income at the time of exercise. Subsequently, when the stock is sold, any gain on the stock is taxed at capital gain rates.

Effects on Company

There also are noteworthy differences between SARs, Phantom Stock and stock options in their effects on the Company.

Cash Outlay

The Company will be required to make a cash outlay in the amount of the SAR or Phantom Stock payments, if such amounts are to be paid in cash. The Company can control the timing of the cash outlay for the Phantom Stock by drafting the Phantom Stock plan in a manner that best meets the Company's needs for performance incentive and cash flow.

The Company typically has less control over the timing of its cash outlay with SARs. While it may be possible for the Company to place restrictions on the timing of SAR exercise, such restrictions may well negate the performance incentive aspects of the SAR. Normally, the Employee determines when to exercise the SAR and the Company cannot control the timing of the required cash outlay.

Generally, no cash outlay is required from the Company upon exercise of a stock option.

Tax Treatment

The Company receives a tax deduction for the amount of the SAR or Phantom Stock payment at the time the payment amount is required to be included in the Employee's income and taxed to the Employee. The amount of the tax deduction is equal to the amount of the bonus payment.

Whether the Company receives a tax deduction for stock options issued to the Employee depends upon whether the option is a statutory or a nonstatutory option. Generally, no deduction is allowed for a statutory stock option because no amount is included in the Employee's income until the stock acquired upon exercise of the option is sold, unless the stock is sold prior to the end of the statutory holding periods.

The Company receives a deduction for a nonstatutory stock option upon the exercise of the option, when the ordinary income amount is included in the Employee's income. The amount of the deduction to the Company is equal to the amount of ordinary income that the Employee is required to recognize upon exercise of the option. No deduction is generated when the Employee later sells the stock.

Withholding

The Company is required to withhold for federal and state income tax purposes and FICA, FUTA and Medicare purposes on SARs, Phantom Stock and nonstatutory stock options granted to Employees. No withholding currently is required on statutory stock options.

If the amount of the SAR or Phantom Stock payment is paid by the Company in cash, the required amount to be withheld generally would be taken from the cash payment. If the SAR or Phantom Stock payment is made wholly in Company stock, or upon exercise of a nonstatutory stock option, the withholding becomes more complicated because no cash to the Employee is paid from which required amounts may be withheld. If the recipient of the stock is an Employee, arrangements generally can be made to have the required withholding amount taken from the Employee's salary. If the recipient is not a current Employee, then alternate arrangements must be made to cover the withholding, perhaps by having the recipient separately pay the required withholding amount to the Company.

Depending upon when in the tax year the SAR or Phantom Stock amount is paid, or the nonstatutory stock option exercised, FICA and FUTA may or may not be required to be withheld. If the payment or exercise occurs later in the year, the Employee may be over the required wage base amount for FICA and FUTA taxes. However, the Medicare withholding tax (currently 1.45% as the Employee's portion) is not subject to a wage base limit and will apply, regardless of the timing of the payment or exercise.

Corporate Charges Against Earnings

For financial accounting purposes, the Company is required to accrue a charge against earnings for the amount of its liabilities under outstanding SARs or Phantom Stock. The amount generally is accrued quarterly in the amount of the quarterly increase in value of the Company's stock (for SARs) or the outstanding Phantom Stock units.

No charge against earnings is required upon the issuance of a stock option, whether statutory or nonstatutory, if the option price equals the fair market value of the stock at the time the option is granted and vesting is based upon attainment of specified periods of continuous service. If, however, the option price is below the fair market value of the stock at the time the option is granted, as permitted with nonstatutory stock options, then a charge against earnings is required for the difference between the option exercise price and the fair market value of the stock at the time the option is granted, times the number of shares of stock subject to the option.

Stock Ownership

Neither SARs nor Phantom Stock involves actual stock ownership by the Employee, unless stock is issued in payment of the SAR or the Phantom Stock. If cash is issued in payment for the SAR or the Phantom Stock, there will be no dilution of Company stock ownership. In addition, the Employee does not receive dividend rights (unless dividend equivalent rights are granted as part of the Phantom Stock plan), nor does the Employee have voting rights.

Stock ownership rights accrue to the Employee upon the exercise of a stock option or upon the payment of SAR or Phantom Stock amounts in Company stock. Such ownership rights include dividend rights and voting rights. Dilution of ownership of the Company also will occur.

Performance Incentives and Encouraging Stock Ownership

SARs and Phantom Stock provide performance incentives only up to the date of cash payment. No performance incentive continues after the payment date unless the payment is made in Company stock.

Stock options provide continuing performance incentives through stock ownership after the exercise of the option, to the extent the Employee retains the shares and does not sell them immediately thereafter.

Obviously, unless the SARs and Phantom Stock are paid in Company stock, neither incentive program encourages stock ownership by Employees, whereas stock options, by their very nature, are designed to encourage stock ownership.

General Effects

There also are noteworthy differences between SARs, Phantom Stock and stock options in their effects on the Company.

Date of Exercise or Payment

As discussed previously, the Company can control the payment date of Phantom Stock bonus amounts, but generally cannot control the date of payment of SARs, unless some form of vesting or other restriction is included in the SAR grant. Similarly, the Company cannot control the exercise date of stock options. Accordingly, if controlling the timing of Company cash outlays or Company tax deductions is important to the Company, Phantom Stock offers the highest level of control to the Company.

Flexibility of Plan Terms

The Company can be quite creative with Phantom Stock in designing a plan that best meets the Company's need. For example, a Phantom Stock plan could include requirements that the recipient continue to be employed, that the payments are subject to vesting, that payments are contingent on the meeting of specific stock or Employee performance criteria and may specify certain events that trigger payment dates. Nonstatutory stock options and SARs also are somewhat flexible. For example, nonstatutory stock options can include variations in terms of plan design, timing, vesting, etc. SARs could be subject to restrictions on date of exercise or vesting requirements. Statutory stock options are the least flexible alternative because the option itself and the stock holding period must comply with numerous Internal Revenue Code requirements in order to obtain preferential capital gains tax treatment and deferral of tax.

Securities Laws

Generally, if SARs and Phantom Stock amounts are paid in cash, federal and state securities laws do not pose an issue. Stock options must comply with securities laws, as must stock issued in payment for SARs and Phantom Stock.

ERISA Coverage

SARs, Phantom Stock and stock option plans, as normally implemented, are not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). However, rights under such plans would be subject to enforcement under state law.

Familiarity

Stock ownership rights accrue to the Employee upon the exercise of a stock option or upon the payment of SAR or Phantom Stock amounts in Company stock. Such ownership rights include dividend rights and voting rights. Dilution of ownership of the Company also will occur.

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fed@fed.org <http://www.fed.org>
