Garland W. Binns, Jr.
Dover Dixon Horne PLLC
Attorneys at Law
425 West Capitol, 37th Floor
Little Rock, Arkansas 72201
Telephone: (501) 978-9923
Facsimile: (501) 375-6484
Email: gbinns@ddh-ar.com
Web Site: www.GWBinns.com

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U P D A T E

News of Developments in the Financial Sector and Related Areas

* *IN THIS ISSUE* *

Phantom Stock Plans

Preemptive Rights

Save Money on Franchise Taxes

Phantom Stock Plans

Phantom stock plans, which are also known as shadow or unit stock plans, are a type of stock based incentive compensation to permit key employees the ability to share in a company's success without giving the employee any actual equity in the business. Phantom stock option plans are generally administered by a committee, selected from non-employee members of the board of directors of the company who will not be participants, that award compensation units to key employees of the company. The award of units by the administrative committee does not convey any actual ownership in the company. A phantom share unit is a credit in a participant's account for an amount equal to the value of the company's actual shares. Once the units are awarded to the participant's account, it is credited with changes in share value, along with dividends and other distributions by the company to its stockholders of actual shares.

Generally, phantom stock plans provide that dividends and changes in a company's capital structure are taken into account in valuing the participant's interest under the plan. If a dividend is paid on the company's outstanding stock, an equal prorated amount is credited to each unit held by a participant. In addition, if a company changes its capital through a stock split or stock dividend, the number of units held by a participant is adjusted accordingly in proportion to the change.

There is generally no taxable income for the participants in phantom stock plans until units are redeemed in the participant's account. At the same time, there is no tax deduction for the company until it becomes obligated to pay the employee for units held in his account. Payments to participants are taxed at ordinary income tax rates.

Since participants in phantom stock plans do not hold "real" shares or have any actual equity in the company, participants are not eligible to vote at stockholder meetings of the company. Phantom stock plans are ideal and provide flexibility for privately owned businesses, since units awarded to participants do not dilute the ownership interest of stockholders of the company. Phantom stock plans are also attractive to Subchapter S corporations. Under the provisions of the Internal Revenue Code, a Subchapter S corporation can have no more than 100 stockholders and may only have one class of stock. Phantom stock units are not treated as a separate class of stock and do not count toward the maximum number of stockholders. Phantom stock plans are an effective tool in providing incentives to attract and retain key employees, while at the same time maintaining the equity interest of the existing shareholders.

Preemptive Rights

Preemptive rights are generally referred to as the rights of existing shareholders to maintain their percentage of ownership of a company by having the right to buy a pro rata number of shares of any future issuances of common stock. Preemptive rights are often bargained for by investors, but usually are not contained in the articles of a company. If preemptive rights are contained in the articles of incorporation, this provision can only be eliminated by a vote of the shareholders.

If a company offers more of its stock, shareholders having preemptive rights are afforded the right to buy the shares to keep their percentage of ownership the same. By having preemptive rights, shareholders can maintain their voting control and share of earnings. However, preemptive rights complicate financing. By forcing a company to offer its shares to existing shareholders before it offers the shares to outside investors, these rights can postpone or effectively eliminate the sale of shares by a company to outsiders.

Preemptive rights can also delay funding by an investor by requiring the company of first offer the shares to existing shareholders, creating a barrier to obtain financing by a company. Companies needing adequate financing and having to raise additional capital should consider eliminating preemptive rights in the event such rights exist in the articles of incorporation of the company.

Save Money on Franchise Taxes

Act 94 of 2003 ("Act 94") amended the Arkansas Franchise Tax Act of 1979 to increase the annual franchise taxes effective for calendar years beginning January 1, 2004. Corporations, bank holding companies and banks (both state and national) organized under the laws of the State of Arkansas will want to consider amending their articles to provide for a par value of $.01 for each share of authorized stock. Bank holding companies and banks in Arkansas generally have a par value of $10.00 per share.

Assuming that a corporation or bank had 500,000 shares of stock outstanding at a par value of $10.00 per share and all of its assets were in Arkansas, a corporation or bank would pay an annual franchise tax of $15,000.00 under Act 94. By amending the articles to provide for a par value of $.01 per share, the corporation or bank would only pay the new minimum annual franchise tax of $150.00, formerly $50.00 prior to Act 94.

A corporation or bank would not want to amend its articles of incorporation to provide for no par value since shares without par value are assessed at a rate of $25.00 per share, which if 500,000 shares were outstanding, would result in an annual franchise tax of $37,500.00 under Act 94.

In Interpretive Letter No. 963 issued in response to a request by our law firm, the Office of the Comptroller of the Currency concluded that a national bank had the authority to decrease the par value of its shares to $.01 per share in order to pay the minimum franchise tax.

Arkansas has two Business Corporation Acts. Although they are somewhat similar, there are material differences. In making amendments to its articles of incorporation, a corporation needs to be careful in selecting the correct Act.

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