LIFE ADVANCED MARKETS

Stock appreciation rights plans

Key employee compensation strategies

While each of your employees contributes to the success of your business in their own way, you may consider a number of employees crucial to attaining critical business objectives.

These key employees may have unique skill sets, specific knowledge and experience in the industry, or bring valuable relationships to the table. Recruiting such employees, incentivizing them to continue their employment, and motivating them to excel in their roles requires the consideration of various compensation arrangements.

At some point, a business owner may consider granting key employees an ownership interest in the company. While this may provide the employee with an incentive to grow the business and maximize its value, **business owners may want to consider the impact of providing employees with ownership rights in their business.**

For example, in many states, minority shareholders have the right to review corporate documents and financials, the right to bring lawsuits against majority shareholders, and possibly even the right to seek a court order dissolving the business.

Fortunately, there are alternative compensation arrangements designed to achieve many of the same advantages that a grant of business ownership may provide – without the potential disadvantages previously discussed. One such arrangement is the stock appreciation rights plan.

A stock appreciation rights plan provides key employees with additional compensation based upon the success of the company.

A stock appreciation rights plan is a contractual agreement between a key employee and an employer whereby the employer promises to pay the employee additional compensation at some point in the future, based on the growth of the stock of the business. In order to receive this additional compensation, the employee is typically required to continue employment for a period of time (the vesting period).

The employee may receive a payout of their vested account balance upon termination of employment, death, or permanent disability (depending on the terms of the agreement). The employee is not taxed until they receive a payout of their account balance.

AMK-518 (R-1/2023)

An example: Employer agrees to pay a key employee additional compensation in an amount equal to the growth on 1,000 shares of company stock. At the time the grant is made, the stock is valued at $100 per share. The agreement requires that the employee continue their employment for a period of at least ten years, at which time their account balance will be paid out. Ten years later, the company has grown significantly and stock is now valued at $190 per share. The value of the employee's account is now $90,000 (the 1,000 shares grew from $100,000 to $190,000). The company then pays out the $90,000 to the employee. The employee will pay income taxes on the amount received and the employer may deduct the payment for income tax purposes.[1]

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Stock value per share	$100	$90	$115	$140	$165	$190
Employee's account balance	$0	$0	$15,000	$40,000	$65,000	$90,000
% vested	0%	0%	0%	0%	0%	**100%**
% vested	$0	$0	$0	$0	$0	**$90,000**

This hypothetical example is provided for illustrative purposes only and is not intended to represent a specific product or security. Clients should consult with their tax advisor and attorney to discuss their specific situation.

Advantages

- Provides a "golden handcuffs" incentive for key employees to continue their employment.
- Employee's future compensation increases with the success of the business.
- Provides a means for key employees to save for future needs (retirement, college expenses, etc.).
- Plan balances grow on a tax-deferred basis – no income tax until compensation is received.
- Provides employee with a financial incentive tied to growth in the company without giving them an actual ownership interest.

Plan design

Implementing a stock appreciation rights plan requires that the employer make certain decisions and consider a number of issues.

Amount to credit

As a nonqualified plan, there are few restrictions on the amount an employer may credit to a key employee's account. In addition, different amounts may be credited to each individual participating employee. The employer will need to determine the appropriate amounts to credit based on a number of factors:

- Value of the business today
- Reasonable growth expectations
- Age of participants
- Current compensation of participants
- Value that each employee brings to the business
- Percentage of profits you are willing to give up in order to retain, attract, and motivate key employees

[1] IRC §162(a)(1)

Distribution events

When will the participant have the right to receive a distribution of their account balance? The most common distribution events include:

- Specified date or age
- Fixed schedule
- Death
- Permanent disability
- Termination from service (involuntary)
- Termination from service (voluntary)
- Change of control in company ownership
- Unforeseeable emergency

Vesting

Each participant's vested account balance will be available to them when a distribution event occurs. The employee will have a right only to the portion of their account balance that is vested. A stock appreciation rights plan does not need to comply with the same vesting limitations as qualified plans do, so the employer may design a vesting schedule that fits their specific goals. In most plans, when a distribution is triggered due to the death or permanent disability of the participant, the account balance becomes 100% vested regardless of the years of service.

Valuation

The appreciation will be based on the difference in value between the grant date and the exercise date. The value will be based on a formula set by the plan document. You have some flexibility in determining what that formula is. The formula should be simple so that the value of each participant's account can be easily, and cost effectively, determined. Some examples include:

- 2 times net annual income
- 1 times EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization)
- Book value (assuming GAAP accounting) plus 1 times net profit

Informal funding

As the value of the stock appreciation units grow, each participant's account balance will be posted on the company's balance sheet as a liability since it represents a future obligation to pay. The employer may wish to set aside funds in order to meet this future obligation.

One option to informally fund the liability is for the employer to acquire a cash value life insurance policy, such as **fixed index universal life insurance** (FIUL), that covers the life of the employee. Such policies may be designed to provide the employer with funds that have the opportunity to grow tax-deferred, access to cash values (via potentially income-tax-free withdrawals and/or policy loans[1]), and tax-free death benefits[2] should the employee pass away before the end of the vesting period.

[1] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change, and you should consult a tax professional.

[2] Death benefit is generally paid to beneficiaries income-tax-free.

Considerations when using an FIUL policy

- Employee must be insurable
- Life insurance requires health and financial underwriting
- Consult with your financial, tax, and legal professionals when exploring this strategy

Costs

An employer will incur certain costs when establishing and administering a stock appreciation rights plan. Costs that the employer should consider include:

- Initial legal fees to draft the plan document
- Professional valuation fees – This will only be the case in plans that contain valuation formulas that value a unit based on variables such as book value, good will, etc.
- Human resources time – Depends on how often the employer wishes to communicate plan account balances with participants. With a simple valuation formula and annual statements to the participants, this should be very minimal.

Compliance with IRC §409A

If a compensation plan meets the definition of a nonqualified deferred compensation plan, it will need to comply with IRC §409A rules in order to achieve the desired deferral of taxation and to avoid additional penalties and taxes. A properly designed stock appreciation rights plan may be exempt from §409A compliance requirements. Employers should seek advice from their professional legal and tax advisors.[1]

TALK TO YOUR FINANCIAL PROFESSIONAL

For more information on how an FIUL policy could informally fund stock appreciation rights plans, contact your financial professional.

[1] IRC §409A(a)(5)((i)(B) – A stock appreciation rights plan will not be considered a nonqualified deferred compensation plan for IRC §409A purposes where: (i) compensation payable under the SAR can never be greater than the difference between the fair market value of the stock on the date of grant of the SAR and the fair market value of the stock on the date of exercise; (ii) the SAR exercise price can never be less than the fair market value of the underlying stock on the grant date; and (iii) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR.