STOCK APPRECIATION RIGHTS PLANS (SARs)

#FP*INSIGHTS*

A critical element in the success of any small business is its ability to recruit, reward, and retain talented advisors and support staff. To this end, equity is often used in addition to, or in conjunction with, compensation to achieve these goals. Synthetic equity is a special set of tools that can provide ownership-level benefits without buying or selling actual stock in an advisory business. A Stock Appreciation Rights (SAR) plan is one of the most common forms of synthetic equity used to align key employees with a business's vision and growth plan.

WHAT ARE STOCK APPRECIATION RIGHTS?

A Stock Appreciation Rights Plan, or SARs, is a deferred compensation plan that provides one or more key employees the cash equivalent of the increase in value of the underlying advisory business's stock over time. SARs are issued at the current fair market value of the shares and provide the holder with the difference between the value at the time of exercise and the value at the time of issuance. One of the major benefits of using an SAR Plan is that there is no money required to exercise the rights for cash (unlike with stock options).

HOW DOES IT WORK?

A Stock Appreciation Rights Plan is customized to fit each advisor's fact pattern and goals. Key terms to better understand this process include: a) the "grant date," which is the date the Stock Appreciation Right is issued to a key employee(s); b) the "grant price," which is the fair market value of the stock on the grant date; c) the "vesting date," which is the day a key employee(s) has a contractual right to receive a future payment (there may be multiple vesting dates), and; d) the "expiration date," which is the last day one can exercise his or her Stock Appreciation Rights. Stock Appreciation Rights are similar to stock options in that they are granted at a set price, and that they generally have a vesting period and an expiration date. Once a Stock Appreciation Right vests an employee can exercise it at specific times prior to its expiration. The proceeds can be paid either in cash, shares, or a combination of cash and shares, depending on the rules set forth in the SARs Plan.

WHO CAN USE THIS TOOL?

Any independent advisor (RR, RIA or IAR, or those with insurance licensure) can utilize an SARs Plan, provided that an entity is approved for use in a professional and compliant manner. FP Transitions' SARs Plans can utilize any of the common structures in this profession—an S-Corporation, a C-Corporation, or any type of Limited Liability Company (LLC) structure. SARs are best used in a fee-based structure or where recurring revenue makes up 70% or more of the annual revenue stream.

WHICH EMPLOYEES SHOULD BE CONSIDERED FOR PARTICIPATION IN A SARs PLAN?

A SARs Plan is a good solution for employees who are well paid in terms of base and bonus compensation, who are highly valued, and who are near an owner/partner level of performance. Examples include lead advisors and C-level officers. SARs can also be used as a retention strategy for key employees as benefits accrue through a time-based vesting schedule (payments may not be received if a key employee is no longer employed or the performance goals are not met).

WHAT PROBLEMS CAN BE SOLVED USING A SARs PLAN?

Stock Appreciation Rights Plans can be very flexible with differences in who gets how much, vesting periods, liquidity concerns, restrictions on selling shares, eligibility, rights to interim distributions of earnings, and participation in corporate governance if these attributes are part of the plan. SARs are often a part of a professional compensation system and are used in place of stock options in these situations: (a) a key employee wants to help grow the value of the business and receive ownership-like returns but is either not ready to, or is unable (perhaps due to a lack of licensing) or unwilling to take on the financial risk of actually buying and paying for equity in the business; (b) an owner wants to focus on growing the value of his or her business but is unwilling—or doesn't have enough time remaining before retirement—to sell and share actual equity, or; (c) to provide one or more key employees with a right to share in the future, appreciated business value and the incentive to remain a key employee through that period of time.

SARs provide a method for a business to give one or more key employees a bonus if the business performs well financially in the future, measured specifically by the increase (if any) in stock value. Key employees also benefit from the flexibility of Stock Appreciation Rights in that they may be able to choose to exercise their rights at any point in between the time the right vests until the time the right expires. SARs are beneficial to employers in that they do not have to dilute share price by issuing additional shares.

HOW IS THE INITIAL EXERCISE PRICE AND THE FUTURE APPRECIATED STOCK PRICE DETERMINED?

SARs Plans follow the price of the underlying stock of the advisory business, a price that is commonly set and tracked by use of a formal valuation or appraisal of the equity value of the business. Once the Stock Appreciation Rights have vested—and at the time the rights are exercised or cashed in—another business appraisal should be performed using the same valuation method and approach to determine the appreciated share value of the advisory business and the size of any award.

WHAT TYPE OF PLAN IS THIS?

There are three main types of synthetic equity plans. 1) **Appreciation only plans** are commonly designed to pay out the value of any increase in the underlying stock value over a certain period of time from the date of the grant. 2) **Full value plans** pay both the value of the underlying equity as well as any appreciation that is earned over a set period of time and can result in a much higher payout to an employee than an appreciation only plan. 3) **Performance unit plans** often exchange the use of equity as the measure of value for another metric such as growth in revenue or profitability to achieve similar objectives. An FP Transitions-prepared Stock Appreciation Rights Plan is set up as an **appreciation only plan**.

IS A VESTING SCHEDULE USED?

Yes, in most cases. The recipient of a SARs benefit often has to wait—usually for a predetermined period of time—to be entitled to exercise the right and receive any award. SARs are designed to provide an incentive to non-owners to help grow the value of the business and to "think like an owner." It is an incentive that must be contributed to by owners and SARs Plan participants as well and earned, over time.

HOW DOES A KEY EMPLOYEE RECEIVE VALUE FROM A SARs PLAN?

Generally, a participating employee will receive his or her payment like any other cash bonus, though SARs may also pay the bonus in company stock, per the plan document. Actual payment of the SARs benefits is usually deferred until a predetermined date or until the employment relationship is formally terminated due to retirement, death, or disability. In an FP Transitions-prepared Stock Appreciation Rights Plan, employers commonly pay this type of bonus in cash.

HOW ARE THE BENEFITS OF A STOCK APPRECIATION RIGHTS PLAN TREATED FOR INCOME TAX PURPOSES?

It is taxed as ordinary income at the time it is paid, or vested, less any consideration paid for it (usually none) and is deductible to the employer. FP Transitions' SARs plans are deferred-compensation plans and, as such, must be designed and documented to conform to the requirements of section 409A (IRC). Accordingly, for income tax purposes, the deferred compensation attributable to a SARs Plan should not be subject to income taxation to the key employee until it is actually paid to, and received by, the employee.

WHAT IS THE COST TO SET UP A SARS PLAN?

The long answer is that it depends on the number of people you would like to provide the benefits of SARs to and the period of time the benefits are to accrue. The short answer is that a basic SARs Plan has a starting, flat-fee cost of $5,000 associated with the planning, drafting, and implementation work for the plan, not including the business valuation.

WHAT TEAMS AND SKILLS AT FP TRANSITIONS ARE INVOLVED IN THIS PROCESS?

FP Transitions' Legal Team will handle the drafting and implementation steps. The FP Transitions' Valuation Team will provide an industry-specific appraisal to accurately determine the starting share value. On occasion, and when needed, support will provided by the Consulting Team and the Analytics and Compensation Team as well to help determine eligibility, plan type, plan funding, grant points, performance time periods, and vesting schedule.

For more information, including benefits, detriments, and caveats associated with a SARs plan, be sure to read our white paper, *Synthetic Equity: An Innovative Approach to Compensation*, which can be downloaded at fptransitions.com/syntheticequity.

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