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Synthetic Equity: An Innovative Approach to Compensation

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Introduction

A critical element in the success of any investment advisory business lies in its ability to recruit, reward, and retain talented advisors and support staff. Synthetic equity is a powerful tool in this regard and can be used by almost all independent advisors. The term “synthetic equity” refers to a set of strategies and tools that are commonly used to provide key employees with some of the economic benefits of ownership, without actual stock changing hands.

To be clear, the process of transforming a single-owner practice into a sustainable business generally relies on equity. Equity, or stock, is what next-generation advisors invest in, and over time and with hard work benefit from, above and beyond what compensation alone can provide. Equity is the shareholder value created in a business managed from a bottom-line-up perspective with a focus on earnings or profits as the ultimate financial goal. Equity is a great building and motivational tool, but the opportunities of ownership come with obligations. Because of these obligations, buying or selling equity isn’t the only way to offer key employees ownership-like benefits, nor is it always the best option.

Synthetic equity plans, sometimes referred to as equity alternatives, generally provide upside economic characteristics of actual equity without the associated debt of buying stock from the founding owner. In most cases, synthetic equity plans mature into cash compensation to the employee with an offsetting deduction for the employer. Because synthetic equity is a form of compensation, it can be readily sculpted in a variety of ways to address virtually any situation.

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SYNTHETIC EQUITY SOLUTIONS ARE USEFUL IN THESE COMMON SCENARIOS:

An owner who wants to share the economic value of equity, but not equity itself, or who doesn't want to provide seller financing to support such a transaction.

A key employee who wants to receive ownership-like returns, but is unable or unwilling to take on the financial risk of actually buying and paying for equity in the business.

An owner who wants to retire and sell his or her practice in five years or less and wants to reward one or more key employees at the time of the sale without those employees actually having to buy and pay for equity beforehand.

An owner who wants to not only provide a key employee with incentives for growing the business but also needs to create strong disincentives against the employee leaving and competing with the business, soliciting clients, or acting in a manner detrimental to the business itself.

A key employee who is interested in equity but is unwilling to sign personal guarantees or take responsibility for issues such as an office lease, a line of credit, payroll costs, or the obligations inherent in a buy-sell or continuity agreement.

A key employee who desires to be an owner but who does not have the necessary licenses or qualifications to be a full equity partner.

A key employee who is young and eager for ownership but isn't yet ready to take on a leadership role.

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How Does Synthetic Equity Work?

In its purest form, synthetic equity requires an entity structure and a growing and profitable business to be worthwhile. Both LLCs and corporations are eligible to use these tools; sole proprietorships can use similar tools under the right circumstances.

One way to understand the concept of synthetic equity is to consider how actual equity works and to borrow the needed tools from that toolbox. To that end, owning equity in an independent financial advisory business typically provides benefits that include:

1. Voting rights
2. Limited liability
3. A proportional share of the profits
4. An opportunity for capital appreciation
5. Long-term capital gains tax rates on sale
6. Access to financial records about the business
7. A voice in the business's governance structure

These are substantial benefits. This "bundle of rights" has measurable value which is why there is a cost when buying equity and a tax implication when granting equity to an employee. In most cases, equity in a financial services or advisory business is purchased and paid for on an after-tax basis; even a small ownership stake in a fee-based business can cost several hundred thousand dollars. In exchange for taking the investment risk, an equity partner or shareholder generally expects to receive this full bundle of rights.

What isn't commonly understood is that the rights in this bundle are separable—an existing owner doesn't have to sell or grant the entire bundle of rights to a key employee or advisor/investor. In addition, each of the listed rights can be further broken down or redefined with almost surgical precision to meet the specific objectives at hand. A key employee might be granted, for example, just one or two rights from the full bundle such as the ability to share in the appreciation of the business's value, or a portion of the profits, or both. Synthetic equity creates a benefit that stems from owning less than all of the rights in the bundle. These individual rights, or benefits, are usually set forth in a plan document and often delivered through a separate award agreement(s)—a contract between the employer and employee. Combining equity-like benefits with a long-term compensation strategy results in a host of customizable choices for building a strong and valuable business.

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THREE MAIN TYPES OF SYNTHETIC EQUITY PLANS:

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.

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.

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.

These types of plans resemble traditional non-qualified plans in many respects as they can be discriminatory in nature and are most commonly subject to a substantial risk of forfeiture that does not end until just before the benefit is actually paid to the employee.

Synthetic equity is ultimately a form of deferred compensation that connects an employee's financial reward to the success of the company. Each plan is custom designed to fit the specific needs of the advisor by finding the right balance between the risk of losing a valuable employee and the potential future cost to the employer. The plans are designed to reward key employees for helping to grow the company, but also recognize that if the business doesn't grow or the key employee doesn't fulfill his or her part of the bargain (i.e., they leave to work for a competitor or start their own practice), no payment may be owed.

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Important Guidelines and Limitations

Here are some guidelines for this white paper that will streamline the discussion and narrow the scope of the material to be covered:

1. "Stock" is a term that is applicable to a corporation. In that many independent advisors prefer to use an LLC as their entity structure, we will use the terms "units" to apply to an ownership interest in an LLC, and "equity" as a generic term for stock or units.

2. We will use the terms "stock" or "units" to mean buying and selling actual stock in a corporation or units in an LLC that includes "the full bundle of rights" of stock or unit ownership. Synthetic equity is a term that refers to owning something less than all of the benefits of full equity.

3. We will assume that any benefits paid out to key employees under a synthetic equity plan are paid in cash and that such cash payments are paid in full upon vesting and are not subsequently further deferred in terms of payment.

4. We will generally assume that any benefits to be paid out to key employees under a synthetic equity plan will not be settled with stock or units, even though that is a possibility to consider.

5. Restricted stock or restricted units are not treated as a synthetic equity planning element in this white paper.

6. Stock options are non-qualified options.

7. The synthetic equity plans discussed herein are not tax-qualified plans and are not intended to cover a broad group of employees. To avoid violating the Employee Retirement Income Security Act of 1974, as amended (ERISA), participation in a synthetic equity plan is assumed to be limited to a select group of key employees. In addition, those key employees may need to be licensed under FINRA rules depending on the type of plan and the benefits offered.

Synthetic equity plans can be designed well beyond these limitations, but the complexities and regulatory issues often require consultation with a tax attorney and/or ERISA specialist. For most independent advisory practices and businesses, certainly those with about $2 billion or less in AUM, the guidelines and limitations above tend to work well in designing a practical and efficient synthetic equity plan.

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Synthetic Equity Planning Elements

Independent financial advisors that utilize a corporate entity structure often intuitively understand the basic concepts of synthetic equity; the commonly used approaches include phantom stock plans (PSPs), stock appreciation rights (SARs), and stock options. These are three concrete examples of synthetic equity and provide an excellent opportunity to better understand the functionality of such plans. It is important to note that these approaches (PSPs, SARs, or stock options) are best thought of as umbrellas under which many different plans can be constructed to address an independent advisor's specific goals and fact pattern.

PHANTOM STOCK PLANS

Phantom stock, sometimes referred to as ghost stock or shadow stock, provides employees access to some of the benefits of stock ownership without actually buying or owning the stock. As a general rule, one share of phantom stock is equal in value to one share of actual stock in the business. Phantom stock follows the price of the underlying stock of the advisory business, a price that is set and tracked by use of a formal valuation or appraisal. The number of phantom shares granted to a key employee depends on that person's perceived value to the business. The more an employee is valued, the more shares of phantom stock he or she is likely to receive.

PSPs are an example of a full value plan in that they include the underlying value of the stock, which connotes substantially more immediate value to the recipient. In turn, employment taxes are due on the value received when vested. As a result, a vesting schedule is often used, creating a substantial risk of forfeiture for a period of time. The recipient of the PSP benefits has to wait—usually for a pre-determined period of time or until the achievement of a set goal—which, if it does not transpire or come to pass, forfeits all of the benefit. The result is the granted benefit is not taxed until the substantial risk of forfeiture has elapsed and the plan is paid out in cash. Most full value plans are accompanied with a formal and sometimes intricate vesting schedule.

PSPs can be used to create a wide variety of benefits depending on what a business or employer wants to accomplish. This is not a one-size-fits-all document or plan. For example, a key employee can be provided with the right to share in a set percentage of business value payable only upon a change of control or sale of the advisory business. The plan can also provide a key employee with the right to share in a graduated percentage of business value. For instance,

an employee might have a right to 5% of the business's value and can earn an additional 1% for every $1 million in growth in business value up to a maximum of 10% over the next five to ten years. Another possibility is to provide a PSP participant with the right to receive 5% of the value of the business above $1 million. Phantom stock may include a share of ongoing profit distributions.

STOCK APPRECIATION RIGHTS

In contrast to full-value PSPs, stock or share appreciation rights are issued on an appreciation-only basis. The key employee does not receive the current underlying stock value—it is used only to calculate current value. Stock appreciation rights (SARs) provide the recipient with appreciation in the value of a business's shares from the date of issuance. 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. Generally, the employee is subject to ordinary income tax rates on the full amount of the payment (or value of stock) received at the time of exercise and the advisory business receives a corresponding tax deduction.

Let's assume that Employee A receives an award of stock appreciation rights covering 2,000 shares, at a time when each share of stock is worth $10 (based on the underlying stock value). The current value of the stock for use in calculating the final benefit is $20,000. Under the terms of a SARs plan, an employee typically must remain employed with the advisory business for five years, as an example, to benefit from the plan; this is known as the "vesting" period. In most cases, the vesting period is set to accelerate if the business is sold before the end of the vesting period. If the key employee leaves before the stock vests, the benefits are typically forfeited.

Let's assume that at the end of five years, the business has grown and that its stock is now valued at $20 per share, up from $10 per share at the time of issuance. In this example, Employee A is entitled to receive the difference between $10 per share at the outset of the plan and the current $20 per share at the end of five years. His or her stock appreciation rights have appreciated in value. This results in a cash payment to Employee A of $20,000. If, after five years, the business has contracted in value and each share is now worth only $9 per share, no payment is due and owing to Employee A. Conversely, if the advisory business is sold in year four at a value that results in a share price of $25 per share, then Employee A is owed $30,000, provided that Employee A is still gainfully employed by the business at the time of the sale event.

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Employee A will receive his or her payment like any other cash bonus. It is taxed as ordinary income at the time it is received less any consideration paid for it (usually none) and is deductible to the employer. Both stock appreciation rights and phantom stock payments are usually made on a fixed, predetermined date. The liability that accompanies the fluctuation or growth in the advisory business's stock price must be carefully considered as the payment obligation may need to be reported on the business's balance sheet. The business will also need to disclose the status of the plan to all participants on an annual basis and should hire an independent appraiser to periodically value the underlying stock and, hence, the plan.

STOCK OPTIONS

Another form of synthetic equity is the use of stock options. A stock option gives a key employee the right, but not the obligation, to buy stock at today's price at a preset time in the future. A stock option must be issued with a strike price at or above the current fair market value of the company's underlying stock and can have an expiration date as much as ten years in the future.

Stock options can be treated like stock appreciation rights and allow for a "cashless" exercise, or, alternatively, require the employee to pay the exercise price at which point the employee becomes an owner of actual equity of the company. Depending on the terms of the option plan, the employee may be able to sell the shares immediately for cash or could be required to hold the shares under the terms of the shareholder agreement applicable to all shareholders. Ordinary income tax is due at the time of exercise on the difference between the strike price and the then current value.

"Synthetic equity," "phantom stock," and "stock appreciation rights" are not legal terms, so employers often use a more formal and professional title for this benefit in the Plan Agreement or Charter such as an "Equity Rights Award" or a "Share Value Award." Every plan, regardless of what it is called, is custom drafted to fit the particular needs and goals of the business, its current ownership structure, and its regulatory structure. Such plans do not need to be complex. but they must be well thought out and should be supported by a thorough pro forma analysis of the possible outcomes. Synthetic equity plans can serve to support key employee motivation and tenure in an advisory business, especially if a sale of the business is on the horizon—an event that may cause key employees to seek employment elsewhere, which in turn could cause a loss of business value.

Plans for Use in an LLC Taxed as a Partnership

Partnership tax law is more complex but offers benefits otherwise unavailable. The good news is that with the complexity comes a very fluid, flexible, powerful operating structure that can do some amazing things. This section will serve to highlight the important differences between synthetic equity plans designed for an S-Corporation (a common entity choice in this profession) and plans for an LLC taxed as a partnership, and some key advantages of the latter structure.

Unlike corporations, LLCs do not technically issue stock. When an LLC is taxed as a partnership, ownership is usually expressed as a percentage of total ownership (e.g., 90% or 40%) or in membership "units" (e.g., 90,000 out of 100,000 units). Units of ownership are functionally equivalent to shares in a corporation. Units, as a term of art, will be used to represent the full bundle of rights that accrue to an owner.

CAPITAL AND PROFITS INTEREST

Unlike shares in a corporation, an LLC membership unit is comprised of a capital interest and a profits interest. A capital interest primarily represents the capital contribution, or capital account, of a member or owner. A profits interest, on the other hand, represents the appreciated growth in value of the capital account from the time issued plus access to profits tied to that interest, just as the name suggests. The result is that an LLC taxed as a partnership can employ all of the synthetic equity products available to a corporation to reward and retain talent (including a PSP, SARs, and stock options), and it has the advantage of being able to push beyond the traditional synthetic equity boundaries and issue a stand-alone profits interest to key employees, which may further include advantageous tax treatment as explained below.

The recipient of a grant of a profits interest is entitled to receive distributions of future profits from the advisory business and owns any proportional increase in the value of the business which occurs after the date of the grant. Recipients of a profits interest do not share in any value created before the grant date. A profits interest is usually non-taxable at the time of the grant.

As an example of how a profits interest can work, assume that Newco, LLC issues a 3% profits interest to an employee on January 1, 2020, when the fair market value (FMV) of Newco is determined to be $1 million. If the value of Newco increases to $5 million at the time it is sold ten years later, the employee's share of the sale proceeds would be equal to 3% x ($5 million – $1 million), or $120,000,

and taxed as long-term capital gains—not ordinary income. In addition, the key employee will have received 3% of any profit distributions over those ten years. Profits interest can be granted subject to vesting provisions. For example, a profits interest grant may vest over a three-year period or longer, in order to induce an employee to maintain his or her employment until the profits interest has become fully vested. A profits interest vesting schedule can, and typically does, accelerate upon a liquidity event such as a sale of the company. Vesting generally ceases upon termination of employment, except that the interest can be 100% forfeited upon a termination for cause. A business can (but is not required to) structure all profits interest as non-voting membership interests, thus enabling the primary owners to maintain full voting control.

HOW PROFITS INTEREST BENEFITS KEY EMPLOYEES:

Favorable tax treatment As a result of IRS Publication Rev. Proc. 93-27 (as clarified by Rev. Proc. 2001-43), the receipt of a profits interest is not a taxable event, and any resulting distributions received upon a sale of the business are potentially taxed at long-term capital gains rates if held at least two years, and the recipient is treated as a partner for tax purposes whether vested or not. Favorable tax treatment is provided only if the profits interest is issued at or above FMV as of the date of the grant. Any issuance below FMV may be subject to additional taxation and penalties.

Ownership Unlike other forms of synthetic equity, a profits interest is something that is owned by the key employee, subject to the terms of a Members Agreement or Operating Agreement—this is why and how the capital gains tax benefit becomes possible.

No payment upon exercise Unlike stock options, an employee who is awarded a profits interest need not pay an exercise price because the recipient is already viewed as a partner under the tax law. It is relevant to note that an employee who receives a profits interest can no longer be classified as an “employee” of the partnership for tax purposes which means that payment for services is subject to self-employment tax.

Tax and Accounting Issues

Synthetic equity is a form of deferred compensation and as a result is governed by Section 409A of the Internal Revenue Code (IRC). Section 409A of the Internal Revenue Code generally provides that "non-qualified deferred compensation" must comply with various rules regarding the timing of deferrals and distributions. The rules apply to all income and to plans that meet the definition of "deferred compensation." Keeping plans outside the regulatory definition is the simplest and most assured way of avoiding the harsh penalties of non-compliance.

Considerations when designing and implementing a synthetic equity plan include the need for strict compliance with IRC and Department of Labor (DOL) ERISA rules to avoid potential penalties to both the employer and employee, the costs to set up and administer the plan, the need for an appropriate valuation that complies with IRC section 409A (if the plan is not 409A exempt), the unfunded nature of the potential liability, and a business's ability to make the payment when due. From the perspective of the business, it must consider how to properly account for grants of synthetic equity on its financial statements.

Employees are primarily taxed when the right to the benefit is exercised, with tax withheld by the employer. The value of the award—minus any consideration paid for it (usually none)—is taxed to the employee as ordinary W-2 income and may be deductible by the employer. If the award is settled in shares (as might occur with SARs or stock options), the amount of the gain is taxable at exercise, even if the shares are not sold. Any subsequent gain on the shares is taxable at capital gains tax rates.

The Benefits of Using Synthetic Equity

Qualified plans such as 401(k) plans and IRA plans allow employees to save money for retirement and are important benefits to offer in a competitive hiring landscape. However, these employee benefits are generally not considered to be employee retention tools because of annual benefit limits, limited vesting schedules, and other rules that limit an employer's ability to use the plan(s) to reward select key performers. Synthetic equity is intended to be an equity-related tool designed to support a business in recruiting, rewarding, and retaining key employees.

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Additional and important benefits of synthetic equity include:

- Owners of actual equity do not suffer from dilution of their ownership percentages when a synthetic equity grant is made.
- Participating key employees do not purchase phantom shares as full equity shareholders do, so no debt is incurred.
- It encourages key employees to think like owners and focus on growth and shareholder value.
- Participants generally forfeit any benefits under the plan if their employment is terminated before the agreed vesting date.
- Participants typically do not have voting rights or a say in corporate governance, and participants may or may not be eligible to receive profits from the business (depending on the plan).
- If the business does not grow as anticipated and the stock price does not appreciate, no money changes hands.
- It offers more flexibility in class of stock and number of shareholders than S-Corporations, which are generally more restrictive.
- Synthetic equity is not directly governed by the advisory business's Shareholders or Members Agreement and related buy-sell terms.
- Synthetic equity plans provide flexibility in vesting schedules; vesting can occur over time or based on the achievement of certain measurable corporate or individual goals, or any combination.
- Payment timing and terms are adjustable.

The flexibility of synthetic equity options offers significant advantages, but it can also present substantial challenges. Because synthetic equity plans (even within the confines of the more limited and rigid S-Corporation structure) can be designed in so many ways, decisions will need to be made regarding who gets to participate, how much synthetic equity does each person receive, what valuation method will be used, what the vesting rules will be, how to address liquidity concerns, what the eligibility requirements are, as well as what the rights to participate in corporate governance are—among other things.

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Conclusion

Synthetic equity is a powerful tool in the hands of a business builder. It can be used to address the challenge of recruiting, rewarding, and retaining the necessary talent to grow a strong practice or a sustainable business, without the complications of selling and paying for an actual ownership interest. As with full equity, synthetic equity can re-center the focus of a key employee, advisor, or producer, and encourage them to contribute—at every level—to a growing and valuable business.

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