SYNTHETIC EQUITY: AN INNOVATIVE APPROACH TO COMPENSATION

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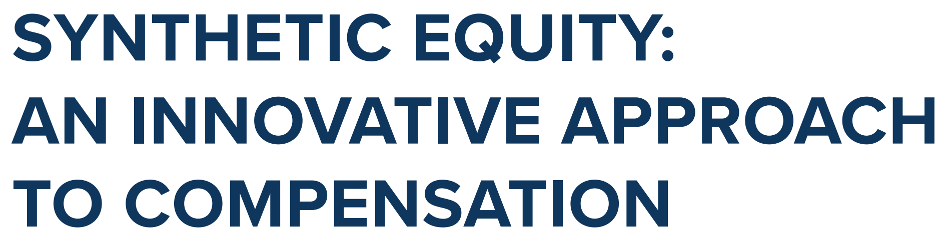

SYNTHETIC EQUITY: AN INNOVATIVE APPROACH TO COMPENSATION

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 the risks or cost of purchasing equity.

The transformation of a single-owner practice into a sustainable business requires an equity centric business structure. Equity, or stock, is what provides next-generation advisors a true stake in an advisory business, and from which, over time, and with hard work, reap the rewards of above and beyond ordinary compensation. 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 the costs and risks of acquiring equity, and the potential dilution to existing owners, true equity is not always the best way to offer key employees with ownership-like benefits.

Synthetic equity, sometimes referred to as an equity alternative, generally provides employees with the upside economic characteristics of ownership without the associated debt or risk of buying stock from the founding owner. In most cases, synthetic equity matures into cash compensation to the employee with an offsetting deduction for the employer. Because synthetic equity is at its heart a form of compensation, it can be readily sculpted in a variety of ways to address virtually any situation.

SYNTHETIC EQUITY SOLUTIONS ARE USEFUL IN THESE COMMON SCENARIOS:

- An owner who wants to share the economic value of ownership with a key employee, to incent the employee to start thinking and acting like an owner, but is not ready to start giving up any real equity.
- A key employee who deserves 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 with a percentage of the value of the business.
- 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 is on track to be an owner but who does not have the necessary licenses, maturity 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?

Synthetic equity requires a business to be both growing and profitable to be worthwhile. LLCs and corporations can utilize these tools, while sole proprietorships are restricted to the long-term incentive plans described below.

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, equity in an independent financial advisory business typically provides a "bundle of rights" that include:

1. Capital appreciation
2. Profit distributions
3. Voting rights
4. Limited liability
5. Long-term capital gains tax rates at sale
6. Access to financial and other business records
7. A voice in business decisions

These rights provide substantial long-term benefits but they do not come for free. Purchases of equity must be paid for (with after-tax dollars) and grants of equity generate tax liability to the recipient. In most cases, sellers ask the buyer to make a career length commitment to the company in exchange for the opportunity to become an owner. New equity partners or shareholders generally expect to receive this full bundle of rights.

What isn't commonly understood is that the rights in this bundle are divisible. Not all are necessarily included in a particular transaction with a key employee. In addition, many of the individual 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 may be the ideal tool to accomplish these objectives.

One benefit of using synthetic equity is that the advisory business can decide which of these rights to convey, and the limitations that may be applied to each right. These individual rights, or benefits, are usually set forth in a plan document and transferred to the employee through a separate award, or grant agreement which forms a contract between the employer and employee. A host of customizable choices exist for using these equity-like benefits within a long-term compensation strategy, all focused on building a strong and valuable business.

FOUR MAIN TYPES OF SYNTHETIC EQUITY PLANS

1. Appreciation-Only Plans are the most common examples. These include Stock Appreciation Rights which provide the employee with the appreciation in value of the underlying equity from the time of the grant to the time of payment.

2. Full-Value Plans, including Phantom Stock, provide the employee with the full value of the underlying equity in addition to the appreciation.

3. Long-Term Incentive Plans, or LTIPS, 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 plans offer complete flexibility in the metric to be measured in exchange for restrictions on how and when the employee is ultimately paid.

4. Profits Interest Plans fall under the category of synthetic equity, but unlike all of the other plan types, a profits interest is actual equity in the upside value of a business. Profits interest plans are only available to businesses taxed as a partnership.

These types of plans resemble traditional non-qualified plans in many respects as they can be discriminatory in nature and may be 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 long-term compensation that connects an employee's financial reward to the success of the company and better aligns the objectives of the employer and employee. Each plan is custom designed to fit the specific needs of the business 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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SYNTHETIC EQUITY PLANNING

Phantom stock plans (PSPs), stock appreciation rights plans (SARs), long-term incentive plans (LTIPs) and profits interest plans are best thought of as umbrellas under which many different specific plans can be constructed to address an independent advisor's specific goals and fact pattern.

Stock Appreciation Rights

In contrast to full-value PSPs, stock appreciation rights are appreciation-only plans. The key employee does not receive the current underlying stock value—it is used only to calculate the value at which measurement starts. Stock appreciation rights (SARs) provide the recipient with appreciation in the value of a business's shares from the value on the date of issuance to the value at the time of payment. SARs must be issued at, or above, the current fair market value of the underlying shares.

Under the terms of a SARs plan, an employee typically must remain employed with the advisory business for a period of years 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. Similarly, a plan can accelerate vesting in the case of the death or disability of the employee, or in some cases, the founding employer. If the key employee leaves before the stock vests, the benefits are typically forfeited.

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. 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. This results in a cash payment to Employee A of $20,000 less taxes withheld.

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, then Employee A is owed $30,000, provided that Employee A is still gainfully employed by the business at the time.

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 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 may 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.

Phantom Stock Plans

Phantom stock, sometimes referred to as ghost stock or shadow stock, provides employees access to some of the economic benefits of stock ownership without actual stock changing hands. As a general rule, one share of phantom stock is equal in value to one share of actual stock (or a unit in the case of an LLC). Phantom stock value directly tracks the value of the underlying stock of the advisory business, a value that may be established and tracked with 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 full underlying value of the stock. In turn, employment taxes may be due on the value received when vested. A vesting schedule is often used to incentivize an employee to stay with the company for a minimum number of years, or to encourage certain behaviors such as passing the CFP® exam. The recipient is only entitled to receive the benefit if the vesting targets are met, otherwise the benefits are forfeited.

Taxes are not paid in most cases until the plan is paid out in cash (or sometimes stock or units). Generally, the employee is subject to ordinary income tax rates on the full amount of the payment received at the time of payment and the advisory business receives a corresponding tax deduction. Most plans are accompanied with a formal and sometimes intricate vesting schedule.

PSPs can be used to create a wide variety of incentives depending on what a business or employer wants to accomplish. This is not a one-size-fits-all document. An employee might be granted a right to 5% of the business's value now with the right to 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. Phantom stock may include a share of ongoing profit distributions. It rarely, if ever, includes voting rights or any of the other rights of ownership. Plans are commonly designed to pay out in the range of 3 to 10 years.

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Long-Term Incentive Plans

Another form of synthetic equity are long-term incentive plans. These plans are used either when the equity in the business is not the right metric to measure or reward employee performance, or in a sole proprietorship that does not have an entity and corresponding equity to value.

LTIPS are custom designed to fit the needs of the individual business and its key employees. While called long-term, they are commonly of much shorter duration than PSPs or SARs, typically 2-5 years.

LTIPS can be structured around any measurable metric to best incentivize and reward an individual or group of employees. Metrics can be company based, such as revenue growth over a defined period, or designed for a specific employee and tied to employee specific targets such as new clients or net new assets under management.

Many LTIPS measure a target over the first year of the plan, but pay the employee at the end of year 3. These types of plans are then repeated each year. The result is that the employee's LTIP award amount is set at the end of the first year, but the employee must remain employed until the end of year 3 to receive the payment. Putting a new plan in place each year creates an ongoing, long-term incentive to achieve short-term targets each year and stay with the company for the long-term.

For example, a plan could be designed to pay Employee B $5,000 if Employee B brings in net new assets of $1,000,000 in year one of the plan. The plan could further reward Employee A an additional $5,000 for each additional $1,000,000 brought in that year. At the end of year 3, the employee would get a check, less applicable withholding, for the dollar amount fixed at the end of the first year, the measurement year.

Profits Interest Plans

The grant of a profits interest to an employee represents real equity, unlike the other forms of synthetic equity discussed above. It is included in this white paper because it has many of the same characteristics and uses as does synthetic equity and is part of a long-term compensation program.

A profits interest most closely resembles a stock appreciation right in that both provide only the upside economics in the growth of the business. Neither has any underlying value at the time of grant. But, because a profits interest represents real equity in the appreciation of the business, when sold, it is taxed as a capital gain rather than ordinary income. The downside for the employer is that neither the grant of a profits interest, nor its ultimate redemption or sale create a tax deduction for the employer.

Profits interests are only available to LLCs taxed as a partnership. They are granted at the then current value of the partnership such that the IRS views them as having no value at the time of grant and no resulting tax liability. The recipient of a profits interest should be treated from that day forward as a partner, and paid on a K-1 rather than a W-2.

A profits interest can include the complete bundle of rights discussed earlier, but just as with synthetic equity, not all of the rights need to be included. In some instances it is appropriate to withhold ongoing profit distributions and/or voting rights. The other rights are normally included.

A profits interest is not limited by time as are the other synthetic equity plans. Instead, the recipient becomes a party to the company's partnership, or members agreement which governs the profits interest holder's ability to eventually sell the interest. 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, 2023, 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.

The grant of a profits interest often includes a vesting schedule that incents the recipient to stay with the business for a minimum amount of time before gaining the ability to "cash-out" when leaving. One caveat is that the recipient of a profits interest must hold it for at least 2 years before capital gains, rather than ordinary income tax rates, apply.

Because of its powerful tax advantages to the employee, now partner, profits interests are a great alternative for a business that wants to attract and retain talented employees without the need for the employee to buy into the company.

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TAX AND ACCOUNTING CONSIDERATIONS

Synthetic equity is governed by Section 409A of the Internal Revenue Code (IRC). These statutes and regulations require that "non-qualified deferred compensation" must strictly comply with various rules regarding plan design and the timing of deferrals and distributions.

Stock appreciation rights and phantom stock plans must comply with the plan design and distribution rules imposed by the IRC. Even slight variance from these rules can result in onerous tax penalties. Violations are subject to income tax on the full value of the award at the time the penalty is incurred, plus an additional penalty tax of 20%, plus penalty taxes in some states plus interest. Penalty taxes are due whether or not the employee has been paid anything under the plan, and the employee, not the employer, is liable for the taxes.

Keeping plans outside of the definition of deferred compensation, and the possible associated penalties, is most easily accomplished through what is known as the short-term deferral exception. So long as a plan pays out no later than March 15 of the year following the year in which the plan vests, or payment is "due" in IRS parlance, the short-term deferral exception applies. LTIPS should always be designed in compliance with the short-term deferral rules.

Profits interests are not subject to section 409A, but can be subject to IRC section 83(b) which determines when income is received in the eyes of the IRS. To forestall an adverse decision by the IRS, if a profits interest does not fully vest at the time of grant, it is often recommended that the recipient file an 83(b) election at the time of grant. This election tells the IRS to "tax me now" at the time when there is no value to the grant, and no taxes are due.

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 the 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 must all be taken into account. From the perspective of the business, it must also consider how to properly account for grants of synthetic equity on its financial statements.

Employees are primarily taxed when the benefit is paid, with tax withheld by the employer. The amount of the payment 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), the value of the shares received is taxable, even if the shares are not sold. Any subsequent gain in the value of the shares is taxable at capital gains tax rates.

Every plan, regardless of what it is called, should be custom drafted to fit the particular needs and goals of the business, its current ownership structure, its regulatory structure, and its employees. Such plans do not need to be complex. 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.

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, and to distinguish an employer from its competitors.

The flexibility of synthetic equity 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.

CONCLUSION

Synthetic equity is a powerful tool in the hands of a business leader. It can be used to address the challenges 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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