

Stock Appreciation Rights Plan

You have recently hired your replacement or other key employee and you want him or her to stay long term and to help grow your business. What do you do to motivate him or her to stay and to perform?

First, you could offer stock. Doing so, however, is probably premature and may be expensive. After all, he or she might not be the right fit, long term or even short term. In addition, he or she may not even want ownership.

Second, you could offer cash, but remember that cash alone has no strings to bind him or her financially to the business.

As a third option, you could create a deferred compensation plan with the future benefit subject to vesting and that future benefit being determined by the future profitability, cash flow, or value of your business. This option is worthy of further consideration, especially if the *amount of that future benefit is tied to the increase in business value measured from a date after the employee commences employment.*

One tool, and perhaps an appropriate one for the job, is a Stock Appreciation Rights Plan, or SAR Plan.

A Stock Appreciation Rights Plan may meet both the needs of the key employee and of the owner, because it gives employees something that looks like stock, grows in value like stock, and can be turned in for cash just like stock, but is not stock.

As employees strive to make the company more valuable, they make their interest in the SAR Plan more valuable. Typically, participation corresponding to shares of stock—but not representing actual ownership—are allocated to the participating employees' accounts. As the value of true stock increases, so does the value of the employees' rights in the participation units.

Tax Treatment

When the employee terminates his employment, the company typically pays him the per share equivalent



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value of each of the participation units vested in his account. The amount received is taxed as compensation to the employee and consequently is deductible to the company.

The success of a Stock Appreciation Rights Plan depends on careful design of vesting, forfeiture, payment schedules and funding devices. The benefit formula used in Phantom Stock Plan is the value of the company's stock.

If all this sounds strangely like the terms of a Phantom Stock Plan, you are correct. The difference, however, between a Phantom Stock Plan and a SAR plan is the definition of the benefit offered. In a Phantom Stock Plan the benefit is the value equal to a portion of the entire value of the business—Phantom Stock units equal to, for example, five percent of the value of the company are worth just that—five percent of the company. SAR units based on five per cent of the value of the company, however, are valued on the future appreciation or growth in value of five percent of the company from the date of the SAR grant. The original value is not part of the benefit.

For example, let's assume that a key employee is granted an SAR benefit equal to five percent of the future growth of a business which has an enterprise value of \$1 million. Further, assume a ten year vesting schedule (ten percent vesting per year). After five years, let's assume that the enterprise value has increased to \$1.5 million. The key employee's vested benefit is calculated as follows:

1. Growth in value (\$1.5 million less \$1 million) = \$500,000
2. Key Employee's SAR five percent benefit = \$25,000
3. Key Employee is 50 percent vested in \$25,000 = \$12,500

SAR plans work well as incentive plans when the company can expect significant future growth and to motivate newer employees whose past efforts have not contributed to existing value.

It is not uncommon for one company to implement both an SAR Plan and a Phantom Stock Plan. Each plan, for the reasons mentioned above, may apply to a different key employee. SAR Plans are often ideal when owners want to reward key employees based on the future growth in value of the company. When you think about it, isn't that precisely the goal we want our employees to achieve?

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