



Center for Private Company Excellence Webinar
Long-Term Incentive Plans

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Learning Objectives

1. Review different types of long-term incentive compensation plans
2. Obtain an understanding of how long-term incentives are utilized
3. Focus on phantom stock and stock appreciation rights (SAR) plans
4. Learn about the design elements of a typical SAR agreement, including the accounting and tax related issues



POLLING QUESTION



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Why Utilize Long-Term Incentives?

- ✓ Attract talent to an organization
- ✓ Retain talent to an organization
- ✓ Reward employees for their contributions for the value they help create
- ✓ Align goals of owners and management
- ✓ Create value for shareholders

Focus of Discussion

- ✓ Nonqualified plans
- ✓ Limited participants
- ✓ Employees with an ability to influence the performance of the business

Types of Long-Term Incentive Plans

1

Equity/Stock Plans

- Stock Grants
- Stock Option Plan

2

Phantom Stock Plans

- Full Value Phantom Stock Plan
- Stock Appreciation Rights Plan/Phantom Stock Option

3

Other Incentives

- Profit Pool
- Nonqualified Deferred Compensation Plan

POLLING QUESTION



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Equity / Stock Plans – Stock Grants

Concept	Objective	Tax Treatment	Impact on Current Ownership
<ul style="list-style-type: none">• Participant receives stock as an alternate form of compensation• Participant receives stock for meeting specific goals	<ul style="list-style-type: none">• Reward participant with ownership representing historical value	<ul style="list-style-type: none">• Non-cash compensation reported on participant W-2 when stock received (ordinary tax rate)• Company takes compensation deduction when stock is granted (ordinary tax rate)• Participant is taxed at capital gain rates when stock is sold (long or short)	<ul style="list-style-type: none">• Issuance of shares dilutes existing ownership

Equity / Stock Plans – Stock Option Plan

Concept	Objective	Tax Treatment	Impact on Current Ownership
<ul style="list-style-type: none">• Participant receives stock as an alternate form of compensation• Participant receives rights to purchase stock at a fixed price• Rights may contain restrictions	<ul style="list-style-type: none">• Reward participant for tenure with company• Meet certain restrictions (vesting or triggering events)• Often used by start-ups as an alternative to cash compensation	<ul style="list-style-type: none">• Non-cash compensation reported on participant W-2 when option exercised (ordinary tax rate)• Company takes compensation deduction when option exercised (ordinary tax rate)• Participant is taxed at capital gain rates when stock is sold (long or short)	<ul style="list-style-type: none">• Issuance of shares dilutes existing ownership

POLLING QUESTION



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Other Incentives – Profit Pool

Concept	Objective	Tax Treatment	Impact on Current Ownership
<ul style="list-style-type: none">• Percentage of company profits contributed to a pool that is allocated to participants periodically	<ul style="list-style-type: none">• Simple and flexible form of rewarding participants for achievement with the company	<ul style="list-style-type: none">• Cash compensation reported on participant W-2 when profits paid (ordinary tax rates)• Company takes compensation deduction when profits paid (ordinary tax rate)	<ul style="list-style-type: none">• No impact to existing ownership

POLLING QUESTION



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Other Incentives – Nonqualified Deferred Compensation Plan

Concept	Objective	Tax Treatment	Impact on Current Ownership
<ul style="list-style-type: none">• Company makes commitment to pay an amount at a later point in time• Often subject to meeting certain restrictions	<ul style="list-style-type: none">• Reward participants for tenure with company and for meeting restrictions	<ul style="list-style-type: none">• Cash compensation reported on participant W-2 when benefits paid (ordinary tax rates)• Company takes compensation deduction when benefits paid (ordinary tax rate)	<ul style="list-style-type: none">• No impact to existing ownership

POLLING QUESTION



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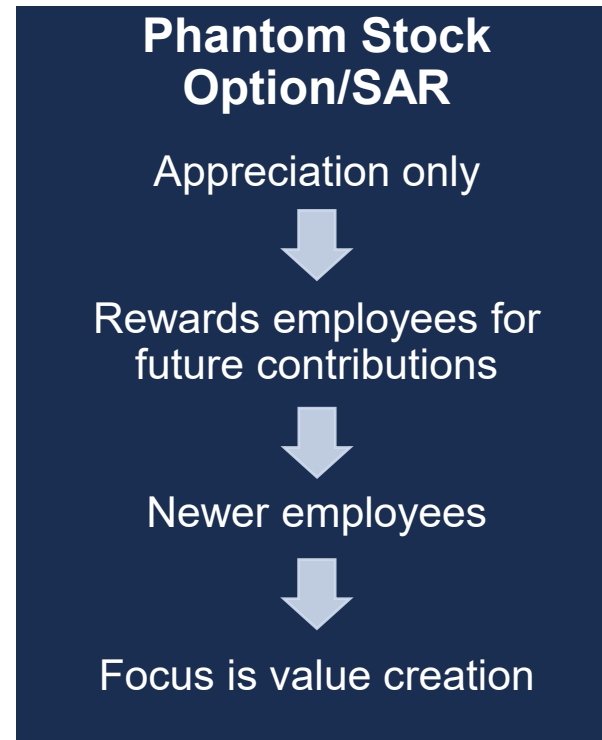
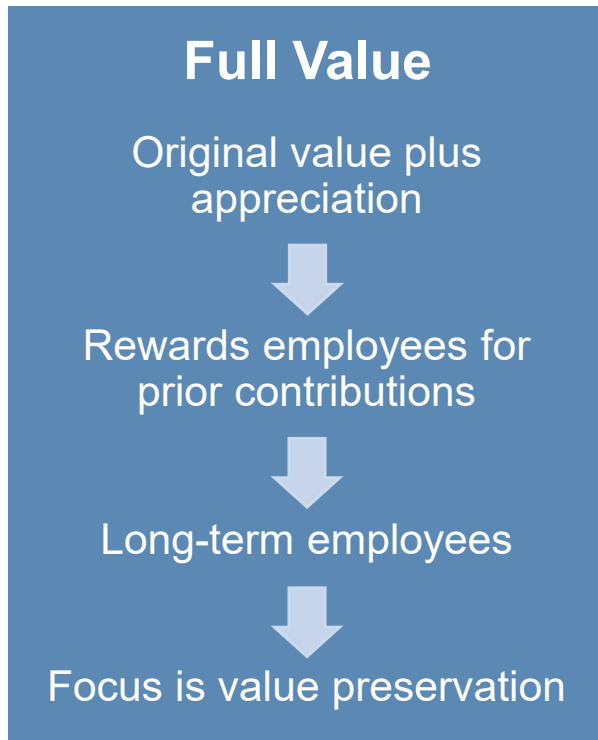
Phantom Stock – Full Value Plan

Concept	Objective	Tax Treatment	Impact on Current Ownership
<ul style="list-style-type: none">• Participants receive a commitment from the company to pay a bonus based on the value of the company stock	<ul style="list-style-type: none">• Reward participants for historical contributions (pending restrictions)• Focus of value preservation	<ul style="list-style-type: none">• Cash compensation reported on participant W-2 when benefits paid (ordinary tax rates)• Company takes compensation deduction when benefits paid (ordinary tax rate)	<ul style="list-style-type: none">• No impact to existing ownership

Phantom Stock – Stock Appreciation Rights Plan/Phantom Stock Option

Concept	Objective	Tax Treatment	Impact on Current Ownership
<ul style="list-style-type: none">• Participants receive a commitment from the company to pay a bonus based on the value of the company stock over a baseline amount	<ul style="list-style-type: none">• Reward participants for future contributions (pending restrictions)• Focus of value creation	<ul style="list-style-type: none">• Cash compensation reported on participant W-2 when benefits paid (ordinary tax rates)• Company takes compensation deduction when benefits paid (ordinary tax rate)	<ul style="list-style-type: none">• No impact to existing ownership

Full Value vs. Phantom Stock Option (SAR) Plan



How a Plan Works

- 1 Employer enters into an agreement with employee
- 2 Employer grants employee units
- 3 Document dictates starting value
- 4 Triggering event occurs and payment made

Provisions in a Phantom Stock Plan

- I. Valuation
- II. Participation
- III. Allocation of Value and Awarding of Grants
- IV. Triggering Events
- V. Payout Provisions
- VI. Vesting



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I. Valuation

Company Value

- Stock Exchange (public companies)
- Third Party Appraisal
- Book Value
- Formula Value



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II. Participation

Legal Restraints

- ERISA
- Nonqualified Deferred Compensation
- Restricted to select management/highly compensated employees

Company Impact

- Which employees will create the value
- Typically no more than 10% of employee population

Capacity

- Comparing value of plan to the participant pool
- Opportunity per participant

Recruiting and Retention Factors

- Urgency in industry market place
- Competition with public companies

III. Allocation of Value and Awarding of Grants

Grant as a Percentage of Salary

- Tier employees (i.e. Tier 1, Tier 2, Tier 3, etc...)
- Percentage of Salary based on Tier Level (i.e. 40%, 25%, 10%, etc...)

Grant Level Amounts by Tier/Position

- Tier employees
- Level grants based on tier (i.e. 1,000 grants, 500 grants, etc...)

Grant Based on Relative Value of Positions

- Responsibilities dictate number of grants
- CEO vs CFO vs COO

IV. Triggering Events



Death



Retirement



Disability



Leave of Absence



Separation
of Service



Change of
Control or Sale

V. Payout Provisions



Lump-sum payment



Installment payments



Interest



Years for payment



Employer controlled – 409A issue

VI. Vesting



Indicates value received upon triggering event



Vesting Commencement Date



Immediate Vesting (uncommon)



Vesting Anniversary Date



Cliff vs Graded Vesting



Acceleration Clauses

Key Agreements



Employee Agreement



Non-Compete Agreement



Release Agreement



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Other Considerations

- Impact to the financial statements
- Company cash flow
- Funding for payments
 - Peace of mind
 - Employee confidence
 - Cost reduction on interest earned



Documentation

- I. Formal Plan Document
- II. Summary Plan (optional)
- III. Employee Enrollment Forms
- IV. Grant Letters
- V. Annual Valuation Statements
- VI. Plan Launch Meeting



POLLING QUESTION



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GAAP Considerations

- FASB ASC 718-10 *Stock Based Compensation*
- Expense recognized over vesting period
- Liability recorded on the books

Tax Considerations

- Corporate deduction when paid
- Ordinary income to recipient when received (i.e. wages)
- Notification to Department of Labor within 120 days of plan's effective date
- Subject to revenue code section 409(A)
- Payroll taxes
 - Full Value Plan – as vested
 - Stock Option Plan – when first payment occurs
- Tax deferred
 - Must be subject to “substantial risk of forfeiture”



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Case Study

- Growth Company
- Family Owned
- Non-Family Executives
- Valuation – Multiple of adjusted EBITDA
- 10 Year Vesting
- 10% Annual Growth Rate
- 5% of Growth to Phantom Stock Participant

Illustrations



Sample Company Phantom Stock Illustration - 15 Year Period

FOR ILLUSTRATION PURPOSES ONLY

1) Determine Baseline Value						
	EBITDA	Normalizing Adjustments	Adjusted EBITDA	Weighted Average	Valuation Multiple	Valuation Discount
					4.0	0.0%
2018	1,875,000		1,875,000			
2019	1,400,000		1,400,000			
2020	2,000,000		2,000,000	1,779,167	7,116,667	7,116,667

2) Illustration of Growth in Value					
Growth Assumption:	10.0%				
Year	Adjusted EBITDA	Weighted Average (3 Year)	Annual Valuation	Annual Valuation Increment	Cumulative Value Over Base Year
2020	2,000,000	1,779,167	7,116,667		
2021	2,200,000	2,000,000	8,000,000	883,333	883,333
2022	2,420,000	2,276,667	9,106,667	1,106,667	1,990,000
2023	2,662,000	2,504,333	10,017,333	910,667	2,900,667
2024	2,928,200	2,754,767	11,019,067	1,001,733	3,902,400
2025	3,221,020	3,030,243	12,120,973	1,101,907	5,004,307
2026	3,543,122	3,333,268	13,333,071	1,212,097	6,216,404
2027	3,897,434	3,666,594	14,666,378	1,333,307	7,549,711
2028	4,287,178	4,033,254	16,133,016	1,466,638	9,016,349
2029	4,715,895	4,436,579	17,746,317	1,613,302	10,629,650
2030	5,187,485	4,880,237	19,520,949	1,774,632	12,404,282
2031	5,706,233	5,368,261	21,473,044	1,952,095	14,356,377
2032	6,276,857	5,905,087	23,620,348	2,147,304	16,503,681
2033	6,904,542	6,495,596	25,982,383	2,362,035	18,865,716
2034	7,594,997	7,145,155	28,580,621	2,598,238	21,463,954
2035	8,354,496	7,859,671	31,438,683	2,858,062	24,322,017

3) Illustration of Phantom Stock Plan Benefits/Funding					
Value Allocated to Phantom Stock Pool @	Cumulative Value of Phantom Stock Pool	10 Year Vesting Schedule	Vested Employee Balance	Annual Employee Vested Benefit	
5.0%					
44,167					
44,167	44,167	10%	4,417	4,417	
55,333	99,500	20%	19,900	15,483	
45,533	145,033	30%	43,510	23,610	
50,087	195,120	40%	78,048	34,538	
55,095	250,215	50%	125,108	47,060	
60,605	310,820	60%	186,492	61,384	
66,665	377,486	70%	264,240	77,748	
73,332	450,817	80%	360,654	96,414	
80,665	531,483	90%	478,334	117,680	
88,732	620,214	100%	620,214	141,880	
97,605	717,819	100%	717,819	97,605	
107,365	825,184	100%	825,184	107,365	
118,102	943,286	100%	943,286	118,102	
129,912	1,073,198	100%	1,073,198	129,912	
142,903	1,216,101	100%	1,216,101	142,903	

DEFERRED COMPENSATION EXPENSE RECOGNITION MODEL

Enter Date of Award: 01/01/21

Enter First Fiscal Year-End: 12/31/21

Enter Value of Award: \$ 44,167

Enter Service Period (in years): 10

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Total
Straight-Line Allocation	4,417	4,417	4,417	4,417	4,417	4,417	4,417	4,417	4,417	4,417	0	44,167
Amount of Year 1 earned	4,417	-	-	-	-	-	-	-	-	-	-	4,417
Amount of Year 2 earned	2,208	2,208	-	-	-	-	-	-	-	-	-	4,417
Amount of Year 3 earned	1,472	1,472	1,472	-	-	-	-	-	-	-	-	4,417
Amount of Year 4 earned	1,104	1,104	1,104	1,104	-	-	-	-	-	-	-	4,417
Amount of Year 5 earned	883	883	883	883	883	-	-	-	-	-	-	4,417
Amount of Year 6 earned	736	736	736	736	736	736	-	-	-	-	-	4,417
Amount of Year 7 earned	631	631	631	631	631	631	631	-	-	-	-	4,417
Amount of Year 8 earned	552	552	552	552	552	552	552	552	-	-	-	4,417
Amount of Year 9 earned	491	491	491	491	491	491	491	491	491	-	-	4,417
Amount of Year 10 earned	442	442	442	442	442	442	442	442	442	442	-	4,417
Amount of Year 11 earned	0	0	0	0	0	0	0	0	0	0	-	0
Allocation	12,936	8,520	6,311	4,839	3,735	2,852	2,115	1,485	932	442	-	44,167

Sample Phantom Stock Annual Statement

ABC Science & Technology Company

YEAR- END STATEMENT

Date: January 31, 2022

Plan: Phantom Stock Plan – Ohio Division

Participant : Sample Employee

Units: 5

Vesting Percentage: 10%

	Description	Amount	Vested Amt
12/31/20	Baseline Value of Ohio Division (5 units)	\$355,833	
12/31/21	Year-end 2013 Valuation (5 units)	\$400,000	
	Increase in Valuation	\$44,167	\$4,417



Questions?

Contact the Presenters



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Steve has a wide range of experience providing accounting, tax and business advisory services to businesses in a variety of industries including manufacturing, distribution, construction, commercial real estate, and professional service organizations. He helps companies analyze and understand their financial position, reviews their buy-sell agreements, and assists with business valuations, structure business transfer plans for family and non-family businesses, and merger and acquisition activities.



Contact the Presenters



Mary-Ann F. Schaller
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Mary-Ann has extensive experiences in various aspects of tax planning and compliance. Prior to joining Kreisler Miller, Mary-Ann worked for Arthur Anderson LLP in the Tax Department, which included the Compensation and Benefits practice. Her responsibilities included oversight of the Form 5500 compliance practice of the local office, designing executive compensation programs, including cash and equity incentive plans, and various nonqualified deferred compensation plans.



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