



How to Attract & Reward Key Employees via Compensation, Profit Participation and/or Ownership



As auto group consolidation continues to be a major trend in auto retail, finding and keeping high-value senior managers becomes more of a challenge.

Pay plans are part of the answer, but many ambitious and talented employees are looking for more creative incentives.

So what does it take to attract top talent these days?

On November 2nd, 2017 Joe Magyar and Tim Daub of Crowe Horwath LLP joined us for an online workshop to share their thoughts about rewarding key employees.

Joe is a partner with the Retail Dealership practice and Tim is a Director working with clients on their executive compensation issues.

Crowe Horwath LLP (www.crowehorwath.com) is one of the largest public accounting, consulting, and technology firms in the United States. Under its core purpose of “Building Value with Values” Crowe Horwath uses its deep industry expertise to provide audit services to public and private entities while also helping clients reach their goals with tax, advisory, risk and performance services.

This report is a summary of Joe and Tim’s comments and suggestions.

.....see their Contact Details on the last page.

“A great employee is like a four leaf clover, hard to find and lucky to have.”
Tammy Cohen Founder of InfoMart

MLK1 - Magyar - How to Attract & Reward Key Employees via Compensation, Profit Participation and/or Ownership

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This presentation will not only discuss how to compensate and attract top talent for acquisitions, but will also explore creative ways to reward and incentivize important key managers.

Experts from Crowe Horwath will explore:

- ✓ Compensation/Equity issues related to acquisitions.
- ✓ What should be considered when offering real equity?
- ✓ What are the drawbacks of offering real equity?
- ✓ Are deferred compensation packages a good idea?
- ✓ Phantom stock – what is it and how does it work?
- ✓ What are stock appreciation rights?

EQUITY OWNERSHIP

Equity ownership as one method to incentivize management is directly linked to overall business success, current performance and long-term growth in the value of the business.

Why equity ownership is used?

Typically, Equity Ownership is used to compensate General Managers, however it is sometimes used for other positions such as CFO, GSM, COO or General Counsel.

- ✓ While most equity positions are limited to a single store, ownership by the COO or General Counsel might be spread across the entire organization or holding company.
- ✓ This is common when the key member of management desires actual ownership, is a psychological hurdle of the manager that cannot be overcome or is necessary to compete for talent in the specific market
- ✓ The manufacturer may require an onsite operator to have an ownership interest when the owner is an absentee, is spread across a large group or is a non-traditional structure.
- ✓ It may be part of an overall business succession plan to transfer ownership control to management over time, often retaining a minority position as part of their long-term investments.
- ✓ Non-traditional ownership structures such as private equity or family office and firms such as Capital Automotive Financial (CAF) will finance a buyout of the majority owner by the minority owner using future profits.

Structuring considerations

Funding is one of the most critical considerations in an equity purchase.

- ✓ GMs and other members of management often lack the liquid resources to invest cash for their ownership stake. So what do they do?
 - ◆ In some cases the dealer could grant ownership over time for services based on meeting performance criteria.
 - This results in ordinary income to the buyer equal to the fair market value of the dealership.
 - ▶ Potential tax implications plus the future nature of the ownership grant can present a significant barrier.
 - ◆ More commonly, the current owner loans the funds to be paid back over time by after-tax distributions from the dealership entity.

- ✓ Valuation may be accomplished by:
 - ◆ A third party appraisal.
 - ◆ A formula based on a multiple of earnings plus the Net Book Value (NBV) of dealership assets minus liabilities.
 - ◆ In either method, minority discounts may be considered to offset lack of control and lack of marketability.
- ✓ How the current owner exits is an important consideration and should be part of the purchase agreement or by a separate shareholder or Buy-Sell agreement.
 - ◆ How current management might end their minority ownership could be handled as: could be by:
 - Retirement.
 - Employment termination.
 - ▶ A mutual separation.
 - ▶ A “For Cause” termination.
 - ◆ Dealership valuation to determine compensation to the minority owner upon exit can vary. Some examples are:
 - Use the same method as the acquisition.
 - Pay a share of the proceeds from the sale.
 - Use the original purchase value.
 - Differences can vary based on the reason for the exit.
 - ▶ For example, a “for cause” termination may carry a lower valuation than retirement.
 - Failure to properly document valuation terms can cause significant problems for a “clean” exit.

S Corporation vs. LLC/Partnership

The type of ownership or tax structure can also be a factor in minority ownership.

- ✓ S Corporation
 - ◆ Requires a full share of equity ownership by the minority partner including pro rata income allocation and cash distributions.
 - ◆ Has only one Class of stock that may or may not have voting rights.
 - Minority owners must share in their percentage equally in all income loss and distribution.
- ✓ LLC/Partnership may have advantages when it comes to minority ownership because there are no pro-rata requirements.
 - ◆ Profits, losses and/or distributions may be determined by specific allocations or formula.
 - Different ownership units with different financial benefits and voting rights are allowed.
 - ◆ “Profits Interest” is a type of ownership without an initial value but does have a right to a portion of the operating profit.
 - ◆ The LLC/Partnership may be structured for the minority owner with a share in the growth in excess of the current value.
 - ◆ The benefit to the minority owner is that there is no need to fund their purchase since it has no value.

- ✓ It is possible to restructure so that an S Corporation forms an LLC as a partner to a General Manager.
 - ◆ This provides partnership level treatment to minority owners while the majority owners continue their interest through the S Corporation.

What we see with dealerships

- ✓ General Manager ownership is in the range of 10-25%.
 - ◆ Typically they start with a lesser initial equity with options to increase over time based on performance
 - ◆ Loaned funds for acquisition tend to be by repayment from profit distributions.
 - ◆ When asked about how to reconcile the difference in earning potential between say a Toyota and a Mazda store when recruiting GMs, Joe explained that the Mazda dealership may require a higher percentage of ownership than the Toyota store to bridge the gap.
- ✓ NBV + a multiple of earnings valuation formula is used for purchase except for:
 - ◆ Termination for cause – limited to the original purchase price
 - ◆ Sale of business – the actual proceeds of the sale determines the valuation.
- ✓ Outside of GMs, ownership in related entities such as warranty companies and real estate partnerships may be used as an incentive for other managers.

DEFERRED COMPENSATION

While equity involves ownership, deferred compensation is purely about cash.

- ✓ **Why deferred compensation is used**
 - ◆ The vesting provision acts as a “golden handcuff”.
 - ◆ Motivates executives to perform at a high level.
 - ◆ Motivates executives to work towards specific objectives, such as the sale of a store.
 - ◆ Aligns executive’s interests with those of the shareholders.
- ✓ **ERISA (Employee Retirement Income Security Act) exemption**
 - ◆ It is important for deferred compensation plans be designed so that they are exempt from most of ERISA.
 - Failure to do so could trigger requirements that will make it cost prohibitive or required to be extended to all employees.
 - ◆ There are three ways for deferred compensation to achieve ERISA exemption.
 - Only non-employees as defined by the FLSA are covered by the plan.
 - Compensation is deferred for only a short period, typically no more than five years.
 - A “Top Hat” plan that is unfunded and maintained primarily to provide deferred compensation for a select group of management or highly compensated employees for periods longer than five years.
 - ▶ Unfortunately, there is not a clear definition of what it means to be a “Top Hat” plan and so it has been largely left up to the courts to decide.
 - ▶ Some factors that courts consider are:
 - Compensation levels of covered employees, both in absolute terms and relative to other employees.

- Percentage of workforce covered by the plan should be small. Typically 5% but no more than 10%.
- Types of positions covered by the plan should be “C” suite or GM or similar executive level.
- Do the covered employees have the financial sophistication to understand the inherent risks of an unfunded plan?
- Degree of influence or bargaining power of covered employees. The more bargaining power the more likely it will be considered a “Top Hat” plan.

✓ **Funding**

- ◆ Deferred compensation must be “unfunded” to avoid taxation upon vesting.
 - “Unfunded” means assets are not set aside and are protected from the employer’s creditors.
- ◆ Informal funding is permitted.
 - None of these examples are considered funded for tax purposes.
 - ▶ Earmarked accounts.
 - ▶ Life insurance is a popular way to fund these arrangements.
 - Tim described some problems with this approach though.
 - ▶ Rabbi trusts, so called because the first one was used for a Rabbi.
 - They are assets placed in a trust that can be used for only two purposes.
 - To pay the manager.
 - To pay creditors in the event of insolvency.

✓ **General plan design**

- ◆ Decide if it is to be a defined contribution or a defined benefit plan.
 - A Defined Benefit plan might be designed to pay the executive \$100,000 for 10 years upon retirement.
 - A Defined Contribution plan sets the amount to be contributed and upon retirement, the executive gets whatever is in the account.
- ◆ Are deferrals provided by the employer, employee or both?
- ◆ Is the deferred amount decided at the dealer’s discretion or is it formulaic?
- ◆ How are earnings credited under the defined contribution plan?
 - Fixed rate.
 - Discretionary rate.
 - Variable rate tied to an index or some other known rate.
 - Based on the rate of return of company stock.
 - Based on investments elected by executives.
 - ▶ Tim typically sees this at larger companies.
- ◆ When does the plan vest?
- ◆ What is the timing and form of distributions?

✓ **Tax and accounting**

- ◆ Assuming that the plan is 409A compliant then income taxation occurs when payment is made.

- FICA taxation generally, but not always, occurs upon vesting depending on the type of plan.
 - ▶ A Defined Contribution plan is paid upon vesting.
 - ▶ A Defined Benefit plan is paid upon payment or when the present value can be calculated.
- ♦ The Employer gets the deduction when deferred compensation is paid.
 - This can be confusing if the employee payment is not made in the same tax year as the employer.
 - ▶ For example if the dealer's 2018 tax year starts on July 1, 2017 and the employee is paid on Dec 2017, then the dealer cannot take the deduction until 2018.
- ♦ Under GAAP, deferred compensation liability must be accrued on the employer's financial statements in a systematic basis over the period during which the benefits are earned.
- ✓ **409A compliance**
 - ♦ American Jobs Creation Act of 2004 created Section 409A of the Internal Revenue Code.
 - A 409A violation results in the taxation of vested benefits, additional 20% penalty tax, and sometimes an additional tax intended to represent earnings on unpaid taxes from the year of vesting until the year of the 409A violation.
 - The takeaway is – make sure that you are compliant, because the negative consequences fall wholly on the employee.
 - ♦ It is critical that the plan be in writing and addresses:
 - Employee deferral election rules regarding timing.
 - Distribution rules and specific pre-determined payment provisions.
 - ♦ Violations are often discovered as part of the due diligence process for a pending transaction.
 - This could slow or stop a sale.
 - Voluntary correction programs are available, but they are not always helpful.
- ✓ **What we see with dealerships**
 - ♦ Deferred Compensation plans are primarily used for general managers and CFOs.
 - ♦ The benefit is often tied to a percentage of dealership profits.
 - ♦ Many are funded with life insurance.
 - ♦ “Phantom stock”, which is a cash plan that mimics real stock, ties deferred compensation to the performance of company stock and it is becoming more prevalent.

THE BENEFITS AND DRAWBACKS OF EQUITY AND DEFERRED COMPENSATION

- ✓ **Equity Ownership**
 - ♦ **Benefits**
 - The participant is a “real” owner
 - The manufacturer may require an onsite owner/operator.
 - It is a mechanism for succession planning that transfers over time
 - ♦ **Drawbacks**
 - They can be difficult to unwind.
 - May be difficult for the participant to come up with the financial investment.

✓ Deferred Compensation

♦ Benefits

- Flexibility of plan design within the parameters of 409A.
- It drives specific focus and motivation.
- Golden handcuff.

♦ Drawbacks

- 409A requirements can be tricky without adequate planning.

CONCLUSION

Well-designed plans are effective ways to motivate managers and move the financial needle.



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