Larson Gross
CPAs & Consultants

Use Stock Appreciation Rights Instead of Equity to Incentivize Employees

Many business owners would like to incentive and reward employees based on the increases in the value of their company. A stock option plan can achieve this, but some owners may be reluctant to expand their cap table with additional equity owners. In this case, providing stock appreciation rights might be the perfect solution.

Stock appreciation rights, or SARs, are a unique type of compensation that provides employees with an indirect form of equity in the company. With stock appreciation rights, employers grant their employees the potential to earn stock profits without the need to purchase any actual stock. Each recipient is given a certain number of SAR units corresponding to a cash-value amount or a predetermined number of company shares.

Over time, if the value of the company's stock appreciates, so does the value of the SARs owned by the employee. When an employee cashes out, they receive either an amount determined at issuance or appreciated value in cash or stock. This incentive-based system helps promote employee loyalty, hard work, and dedication.

How SARs work?

SARs give recipient employees the right to the appreciation in the fair market value of shares over a specified period of time, usually subject to a vesting schedule. They work similarly to stock options in that a SAR gives the recipient the right to receive the appreciated value of company stock during a specific period of time or when the stock reaches a specific exercise price. Yet, unlike stock options, the recipient does not have to make a cash outlay as they would when exercising an option.

When an employee exercises their SAR, they can receive either a cash payment or the same value in company stock. The value they receive will be based on the increase in the fair market value since the date the SAR was granted. For publicly traded companies, this value is easy to determine. However, private companies that issue SARs will have to determine fair market value in another manner. Private companies must use a reasonable valuation method, which may require a third-party appraisal or the use of an express written formula.

Advantages of SARs

For employers, stock appreciation rights offer stock options without the direct costs of granting equity. This means that companies that wish to provide their employees with an incentive reward beyond their salary can do so without incurring significant associated costs. Since equity ownership does not transfer upfront or at all, depending on the terms of the program, SARs enable companies to reward their employees without diluting ownership.

In addition, these awards can be tailored in a way that best suits the company, such as through a structured vesting schedule or even restricted or unlocked access at certain milestones in the company's growth. Employers also have the flexibility of settling the SAR with either cash or a transfer of shares.

For employees, SARs enable them to benefit from the increase in value of the stock without having to pay to exercise their options.

Disadvantages of SARs

Stock appreciation rights can offer a number of advantages to companies and employees, but there are a few drawbacks that employers need to consider. Most significantly, stock appreciation rights usually carry some upfront costs for the company in terms of legal expenses in designing the program, and for private companies, the costs associated with an appraisal or determining fair market value.

Additionally, companies need to understand all compliance requirements for offering stock appreciation rights, as a failure to do so can result in penalties.

How are SARs taxed?

Stock appreciation rights are taxable at the time of transfer or when they are "cashed out," not at the time of grant.

The employer is entitled to a deduction equal to the amount of income received by the employee at the time of transfer. Stock appreciation rights are also subject to payroll tax when payment is made or shares are transferred.

For example, John is granted a SAR, and the FMV of each share is $10. John exercises his SAR 5 years later, after vesting, when the FMV of each share is $20. The $10 of appreciation per share will be taxable as ordinary income to John, regardless of whether he elects a cash payout or is given shares of stock. At the same time, John's employer can deduct the equivalent of $10 per share.

Final Thoughts

Stock appreciation rights can provide incentive compensation to employees based on increases in the value of the company without having to provide actual equity. This video is intended to provide a brief overview of stock appreciation rights and is not a substitute for speaking with one of our expert advisors. If you would like to discuss Stock Appreciation Rights or other forms of employees compensation, please contact our office. We'd be happy to discuss your unique situation.

About Larson Gross

Ted Larson and Dennis Gross founded our firm in 1949. They built the business based on excellence, passion, integrity, trust and pro-action — values still important to us more than seven decades later.

Even well into their retirement years, Ted Larson and Dennis Gross continued to have the best interest of the firm at heart. Mr. Larson would come into the office on a regular basis to meet every new face and make a personal connection with each of our team members. He remembered the name of every employee, as well as the names of their spouses and children, and would greet clients by name as he passed by the reception desk. Sometimes, you'd even find a newspaper clipping on your desk that Mr. Larson dropped off, highlighting that your son made the honor roll. This is the example of a genuine relationship we strive to embody with our people and clients.

Today, we're led by ten partners who are growing our firm with respect for where we've come from and a new vision for future success. Our 120-plus team members and three offices located in Bellingham, Lynden and Burlington make us the 10th largest public accounting firm in the Puget Sound region. While we're determined to expand our impact and help strengthen as many businesses and individuals as we can, we're also committed to remaining a locally-owned organization. We're incredibly proud of where we've come from and look forward to a future of possibility

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