Long-Term Compensation Alternatives in the Construction Industry

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Agenda

• Why long-term compensation is used
• ERISA exemption
• Funding
• 409A
• Long-term cash incentives/deferred compensation
• Equity-based compensation
• Performance metrics
• Case study #1
• Case study #2
• Case study #3

Why long-term compensation is used

• Serves as a “golden handcuff”
• Motivates executives to perform at a high level
• Motivates executives to work toward specific objectives
• Aligns executives’ interests with those of shareholders
• Serves as a wealth accumulation tool for executives
ERISA exemption

- Important for deferred compensation to be exempt from most of ERISA
- Three ways for deferred compensation to achieve ERISA exemption
  - Only non-employees are covered by the plan
  - Compensation is deferred for only a short period of time
  - Plan is unfunded and maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (file statement with DOL upon establishment of plan to avoid annual Form 5500 filing requirement)

Funding

- Deferred compensation must be “unfunded” to avoid taxation upon vesting
- Unfunded means assets are not set aside outside the reach of the employer’s creditors
- Informal funding is permitted
  - Earmarked accounts
  - Life insurance
  - Rabbi trusts

409A

- Written document required
- Employee deferral election rules
- Distribution rules
- 409A violation results in 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
- Voluntary correction programs are available, but not always helpful
Long-term cash incentives/deferred compensation

- Great flexibility in plan design, including cash bonuses based on multi-year performance periods as well as traditional deferred compensation
- Traditional deferred compensation can use defined contribution or defined benefit approach and can be tied to success of organization, based on retirement income adequacy or completely discretionary
- Income taxes deferred until payment, but generally subject to FICA at vesting
- Generally subject to 409A rules
- Employer deduction for fiscal year in which ends the calendar year of payment ("year with year" rule), unless an "unfunded pension plan"

Equity-based compensation

Appreciation Awards
- Incentive stock options
- Nonqualified stock options
- Stock appreciation rights

Full Value Awards
- Restricted stock
- Restricted stock units
- Phantom stock

Appreciation versus full value

Example
- Assume stock price is $10 per share on date of grant
- Assume 1 full value award is worth 3 appreciation awards
- Is executive better off receiving 30 appreciation awards or 10 full value awards?

<table>
<thead>
<tr>
<th>Future Stock Price</th>
<th>Value of 30 Appreciation Awards</th>
<th>Value of 10 Full Value Awards</th>
</tr>
</thead>
<tbody>
<tr>
<td>$12</td>
<td>$60</td>
<td>$120</td>
</tr>
<tr>
<td>$15</td>
<td>$150</td>
<td>$150</td>
</tr>
<tr>
<td>$18</td>
<td>$240</td>
<td>$180</td>
</tr>
</tbody>
</table>
Comparison of appreciation awards

- Incentive stock options
  - Can qualify for special tax treatment and exempt from FICA
  - Exempt from 409A
  - No employer deduction unless there is a disqualifying disposition

- Nonqualified stock options
  - Taxed upon exercise (income and FICA)
  - Exempt from 409A if certain requirements met
  - Employer deduction upon exercise

- Stock appreciation rights (stock-settled or cash-settled)
  - Taxed upon exercise (income and FICA)
  - Exempt from 409A if certain requirements met
  - Employer deduction upon exercise for stock-settled SARs, but must follow “year within year” rule for cash-settled SARs

Comparison of full value awards

- Restricted stock
  - Taxed upon vesting (income and FICA) unless 83(b) election
  - Exempt from 409A
  - Employer deduction must follow “year within year” rule

- Restricted stock units
  - Income taxation when shares delivered, but FICA taxation upon vesting
  - Subject to 409A unless paid shortly after vesting
  - Employer deduction when shares delivered (although this is not entirely clear)

- Phantom stock
  - Income taxation when paid, but FICA taxation upon vesting
  - Generally subject to 409A
  - Employer deduction must follow “year within year” rule

SETTING PERFORMANCE METRICS

Begin with the End in Mind
Performance metrics

Performance targets are often used to determine the amount or vesting of an award.
Performance metrics commonly used in the construction industry include the following:

Executive Team and Senior Management
- Target EBITDA
- Target Net pre-tax profit before incentives
- # of wins
- Target working capital
- Target margin earned on jobs
- Corporate book value
- # of Contracts entered into during the year with favorable billing/payment terms (project should perform cash positive)
- And many more...

Operations Team
- Projects on schedule (schedule and completion dates)
- Reduction in AR Turnover Days - Improving Collection Rates
- Timely billing on projects
- Target project Margins
- # of reworks
- # of RFIs (requests for information) converted to PCOs (potential change orders) and average number of days per conversion
- Number of variations/issues resolved from original plan during performance of the job
- Number of variations/issues resolved prior to work beginning on the job with the project team
- And many more...

Case Studies
Case Study #1 – “Skin in the Game”

ABC Construction Company is seeking to retain high performing individuals within the Company to ensure future success. The markets where the Company primarily operates are very competitive, and just recently a project manager was hired away by one of the competitors. ABC Construction Company knows they have to do something to help reduce the risk of losing other key employees within the Company.

Through discussions, the team determines they want individuals to have a feeling of ownership in the Company. The owners of the Company also wish for these employees to eventually gain enough wealth to purchase equity in the Company and buy-out their ownership interest, so they can retire. The team determined that the short-term goal would need to have these key individuals feel like they have some “skin in the game”.

Take a moment at your table and discuss what type of plan you would setup and what metric(s) you would use to measure performance.

Case Study #2 – Driving Performance

ABC Construction Company is looking for a way to motivate employees to improve overall performance. Profit margins have been decent for the past couple of years, however, management feels that teams have not reached their full potential. There have been instances where teams have fallen behind schedule and missed completion dates, had a number of reworks on jobs, missed margins, or failed to obtain change orders in a timely fashion which left management having to negotiate at the end. ABC Construction Company management is looking for a way to improve this and reduce the number of these instances occurring.

Take a moment at your table and discuss what type of plan you would consider for this Company and what metric(s) would be used to measure performance to assist in alleviating some of these issues, while motivating employees to perform to their fullest potential.

Case Study #3 – Aligning Performance

ABC Construction Company recently converted to a 100% employee owned company. As a result of the recent transaction, the previous owners wish to continue to participate in the activities of the Company. To help ensure future success, management wishes for the Company to establish a plan that will incentivize senior management to continue to work towards increasing the value of the Company. The Company has considered issuing phantom share units, however, has chosen not to for purposes of setting up an incentive plan. The Company also wishes to retain the previous owner group as these individuals have been instrumental to the success of the Company.

Take a moment at your table and discuss what type of plan you would consider best for the Company and what metric(s) you would use to measure performance.
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Thank You

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