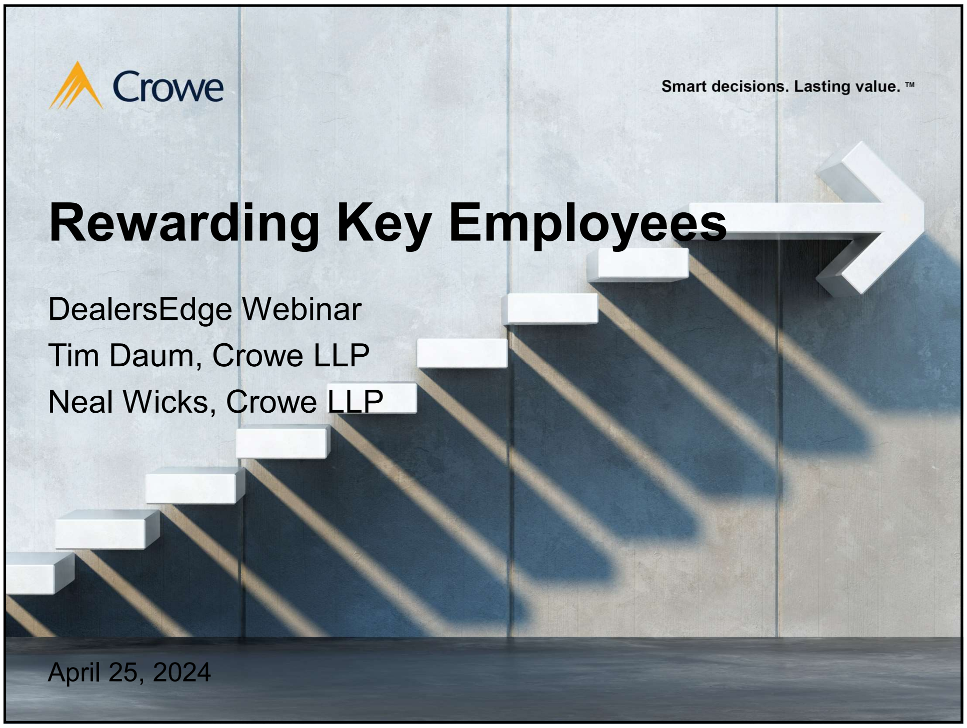

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Rewarding Key Employees

DealersEdge Webinar

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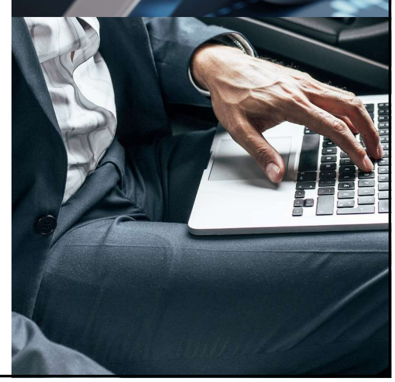
Agenda

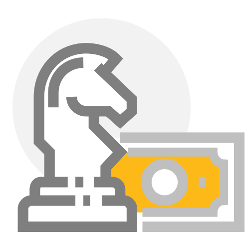
- **Equity Ownership**
  - Why equity ownership is used
  - Structuring considerations
  - S Corporation vs. Partnership/LLC
  - What we see with dealerships
  - General tax rules
- **Deferred Compensation**
  - Why deferred compensation is used
  - ERISA exemption
  - Funding
  - General plan design
  - Tax and accounting
  - 409A compliance
  - What we see with dealerships
- **Summary**
  - Benefits and drawbacks of equity vs. deferred compensation



Equity Ownership

Why equity ownership is used

- Incentivize management directly linked to overall business:
  - Current performance
  - Growth in business value
- Management desires actual ownership, psychological hurdle that cannot be overcome or is necessary to compete for talent in the specific market.
- Manufacturer requirement for onsite operator to have an ownership interest.
- Part of an overall business succession plan to transfer ownership control to management over time.
- Non-traditional ownership structures such as private equity of family office.



Structuring considerations

- Funding
  - Cash
  - Loan
- Valuation
  - Appraisal
  - Formula – NBV plus multiple of earnings
- Exit / Buy-Sell Agreement
  - Criteria
    - Retirement
    - Employment Termination
      - Mutual
      - For Cause
  - Valuation
    - Same method as acquisition
    - Actual if business sold
    - Differences based on reason for exit

S corporation vs. LLC/partnership

- S Corporation
  - Requires full equity ownership
    - Pro rata income allocation and distributions.
  - One Class of stock other than voting/non-voting
- LLC/Partnership
  - Special allocations
    - Profits and/or distributions
  - Allows for voting and non-voting
- Profits Interest
  - Allowed structure with partnership
  - No investment - share only in the profits
    - Operating profits
    - Growth in value
      - Valuation method

What we see with dealerships

- General Manager ownership 10-25%
  - Initial lesser equity with options to increase over time based on performance
- Loaned funds for acquisition
  - Repayment from profit distributions
- Same formula valuation in and out
  - Except
    - Termination for cause – limited to acquisition price
    - Sale of business – actual proceeds
- Related entity ownership
  - Other management in additional to general manager
  - Warranty company
  - Real estate

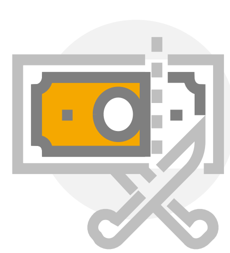
General tax rules

- Equity-based compensation comprises a broad array of types, and therefore a broad array of tax statutes and related regulations/guidance
- Some types of equity-based compensation may be nonqualified deferred compensation subject to IRC section 409A (e.g., discounted stock options), although most are exempt
- Other types of equity-based compensation may be property transfers subject to IRC Section 83 (e.g., restricted stock, partnership interests)
- FICA (Social Security/Medicare) taxation rules vary depending on the type of equity-based compensation
- Deduction rules/timing vary depending on the type of equity-based compensation

Deferred Compensation

Why deferred compensation is used

- Acts as a “golden handcuff”
- Motivates executives to perform at a high level
- Motivates executives to work towards specific objectives
- Aligns executive’s interests with those of shareholders

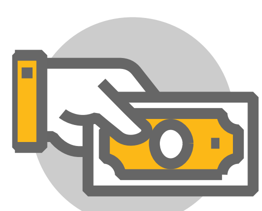


ERISA exemption

- Important for deferred compensation to be exempt from most of ERISA – still may require one-time filing
- 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 – factors to consider in determining whether a plan is a "top hat" plan include the following:
    - Compensation levels of covered employees, both in absolute terms and relative to other employees
    - Percentage of workforce covered by the plan
    - Types of positions covered by the plan
    - Financial sophistication of covered employees
    - Degree of influence or bargaining power of covered employees

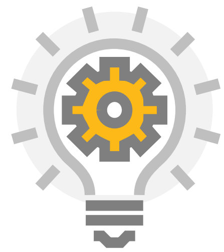
Funding

- 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 generally permitted
  - Earmarked accounts
  - Life insurance
  - Rabbi trusts other than certain offshore trusts or trusts used in connection with the employer's financial health



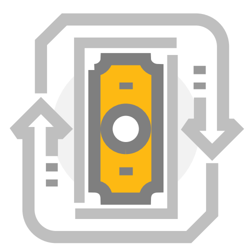
General plan design

- Defined contribution versus defined benefit
- Employer provided and/or employee deferrals
- Crediting of earnings under defined contribution plan
  - Fixed rate
  - Discretionary rate
  - Variable rate tied to index or some other known rate
  - Based on rate of return of employer stock
  - Based on investments elected by executives
- Vesting
- Timing and form of distributions



Tax and accounting

- Assuming 409A compliance, income taxation occurs when payment is made
- FICA taxation generally, but not always, occurs upon vesting
- Employer gets deduction when deferred compensation is paid, although there may be a delay for non-calendar year employers – 409A violation can impact timing of deduction
- Under GAAP, deferred compensation liability must be accrued on the employer's financial statements on 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
- Compliance must be in both form (language/documentation) and operation (administration)
- Employee deferral election rules
- Distribution rules
- Violation results in taxation of vested benefits, additional 20% penalty tax, and sometimes an additional tax representing earnings on unpaid taxes from year of vesting to year of violation - timing of employer deduction can also be impacted
- Violations often discovered as part of the due diligence process for a pending transaction
- Voluntary correction programs are available, but not always helpful

What we see with dealerships

- Primarily for general managers and CFOs
- Benefit is often tied to a percentage of dealership profits
- Many are funded with life insurance
- Phantom stock is becoming more prevalent

Summary

Benefits and drawbacks of equity vs. deferred compensation

- Equity Ownership
  - Benefits
    - Participant mindset of being a “real” owner
    - Manufacturer Requirements
    - Mechanism for succession planning transfer over time
  - Detriments
    - Difficult to unwind
    - Potential participant financial investment
- Deferred Compensation
  - Benefits
    - Flexibility of plan design
    - Drives specific focus and motivation
    - Golden handcuff
  - Detriments
    - 409A requirements
    - One-time ERISA filing may apply

Questions?

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Thank You

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