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***TOPIC: Key Employee Compensation 101: Favorable Economic Conditions Make Effective Key Employee Compensation Programs Critical.***

**MARKET TREND:** The improving economic climate has triggered movement in an otherwise stagnant employment market. Both Boards of Directors and employees are breaking the status quo and making employment changes. Employers are analyzing and adjusting key employee compensation programs to provide the recruiting and retention platforms necessary to ensure the future viability of their organizations.

**SYNOPSIS:** Effective key employee compensation programs serve a myriad of functions, such as recruitment, motivation, performance recognition, retention, alignment with shareholder interests, and succession planning. Program design options and benefits are voluminous and provide employers with extensive flexibility to meet the specific desires and needs of both the employer and the employees.

**TAKE AWAYS:** Key employee compensation programs provide several benefits to employers and employees, including incentives for recruitment and retention, a vehicle for enforcing non-compete and confidentiality covenants, and opportunities for retirement and business succession planning. When consulting with employer-clients on key employee compensation matters, advisors can provide value by helping to ensure that the economics of the benefit and the company's objectives align. Companies should evaluate which program best suits their needs by including the chief financial officer and their outside advisors. Life insurance also should be reviewed, as it can serve as a great informal financing tool for implementation of long-term incentive programs.

**PRIOR REPORTS:** 2013-30, 2013-38, 2013-41, 2013-43, 2013-45, 213-47, 2014-15, 2014-24, 2014-27, 2014-30, 2014-40, 2014-48, 2015-19, 2015-39

An improving economic climate has triggered movement in an otherwise stagnant employment market and motivated employers to analyze and adjust *key employee* compensation programs to provide the recruiting and retention platforms necessary to ensure the future viability of their organizations.

### ***ELEMENTS OF AN EFFECTIVE KEY EMPLOYEE COMPENSATION PROGRAM***

Key employee compensation programs consist of many elements, including base/general compensation, bonuses, perquisites, fringe benefits, health benefits, retirement benefits, long-term incentives, and others. Each serves a specific purpose in an effective compensation program. The following summarizes typical structures or trends for these program elements.

#### **General Compensation**

The program elements of base compensation, bonus, prerequisite (e.g., company plane, security, driver) and fringe benefits (e.g., technology tools, discounted products, special insurance) are generally developed based on an organization's and key employee's history, industry norms, and competition. Over the last two years, managerial pay has generally increased 3% to 6% per year, depending on particular performance results. The trend is to smaller increases in base compensation with greater performance bonuses based on measurable metrics tied to employee responsibilities and operations.

## Health and Retirement Benefits

Health benefits are usually based on the programs for employees in general, especially with the enactment of the Affordable Care Act and the inability to discriminate in favor of highly compensated employees. Some employers are replacing employee medical benefits with supplemental cash compensation.

Retirement benefits similarly are based on general employee programs, exclusive of non-qualified programs. Organizations with favorable demographics, however, can target more generous benefits for employees.

## Long-Term Incentives

**Cash Programs.** Cash programs often pay bonus amounts on performance-based, employer-centric metrics, such as return on investments, return on assets, EBITDA (earnings before interest, taxes, depreciation and amortization), budget achievement, and sales performance. They are earned ("vested") over a performance period (two to five years) and may have an extended payment period (two to four years) after vesting, or until retirement. They will often be subject to special payment provisions in the event of termination with or without cause, death, disability, or a change of control. These programs must be in writing and must comply with Internal Revenue Code ("**Code**") § 409A.

Key employee deferred compensation programs cannot be formally "funded" under law, as the obligation to pay the deferred compensation to an employee at a later date must remain unsecured. However, companies may informally fund these programs by setting aside company assets, and the value of amounts earned can be invested to provide funds to cover future liabilities. Investment preferences can be requested from employees. The liability for benefits also can be effectively offset through the purchase of life insurance on the employees, which generally is not subject to tax on the policy cash value or death benefit while accruing to the benefit of the employer according to longstanding and appropriate tax principles. In either case, however, these assets must remain subject to the claims of the employer's general creditors.

**Equity Programs.** Equity incentives consist primarily of stock options, restricted stock, stock appreciation rights, and phantom stock. Many of the performance and payment triggers are similar to cash programs.

- Incentive Stock Options ("ISOs"). An ISO must satisfy the various requirements under Code § 422(b). The option must be granted pursuant to a plan that is approved by shareholders, the exercise price must be no less than the fair

market value (“**FMV**”) of a share on the grant date, and the option must not be exercisable for a period of more than ten years from the date of grant. Also, pursuant to Code § 422(d), an option will not qualify as an incentive stock option if and to the extent that the aggregate FMV of stock (determined at the date of grant) with respect to which incentive stock options first become exercisable in any calendar year exceeds \$100,000.

If an option satisfies all the requirements for an ISO, the tax consequences relating to that option are as follows:

- The optionee does not recognize any income as a result of the option grant or the exercise of the option. The amount by which the FMV of the stock on the date of exercise exceeds the exercise price is, however, an item of adjustment for purposes of determining the optionee’s alternative minimum tax, if any, for the year in which the option is exercised.
- Upon the optionee’s exercise, his or her tax basis for the stock received is equal to the exercise price.
- Upon a sale of the stock, the difference between the amount realized from the sale and the exercise price is treated as a long-term capital gain or loss, as long as the optionee does not dispose of the shares he or she acquires pursuant to the exercise of an incentive stock option prior to the later of (a) two years from the date the option was granted, and (b) one year from the date the option was exercised, in which case it will be treated as a nonqualified stock option.
- The Company is not entitled to any tax deduction with respect to the option, unless the holding period in (iii) is not satisfied.

- Nonqualified Stock Options (“NQSOs”). A NQSO is any option that does not qualify as an ISO. The tax consequences relating to a NQSO are as follows:
  - The optionee does not recognize any income on receipt of the option (even if the exercise price is less than FMV, unless the exercise price is set so low that the IRS would not view the grant as a true option).
  - The optionee recognizes ordinary income at the time he or she exercises the option equal to the amount by which the FMV of a share on the date of exercise exceeds the exercise price. The amount so recognized is subject to federal withholding and employment taxes if the optionee is an employee.
  - The optionee’s tax basis for the stock is equal to the FMV of the stock on the exercise date.
  - Upon sale of the stock, the optionee recognizes capital gain or loss on the difference between the amount realized from the sale of the stock and the FMV on the exercise date. The gain or loss would be short-term or long-term depending upon whether the stock was held for at least one year after the exercise of the option.
  - The Company is entitled to a tax deduction in the year in which the option is exercised equal to the amount of ordinary income recognized by the optionee (i.e., the amount by which the FMV of the stock on the date of exercise exceeds the exercise price).
- Restricted Stock. Restricted stock is a grant of actual stock that is subject to a substantial risk of forfeiture (such as a requirement that the key employee work for a specified time period before his or her rights to the shares vest). The employee generally will not recognize any income and the company will not be entitled to a deduction until such time as the employee’s rights to the stock become vested. At the time of vesting, the value of the stock is ordinary income and the company would receive a corresponding tax deduction.

The employee could make an election under Code § 83(b) to be taxed at the time he or she receives the stock, even though the stock is subject to a substantial risk of forfeiture. In that event, the employee would be taxable at the time he or she receives the stock, and the Company would be entitled to a corresponding deduction. The employee would take a tax basis for the stock equal to the value at grant, and, when he or she subsequently sells the stock, he

or she would recognize capital gain for any appreciation, which would be short-term or long-term depending on whether the employee held the stock for at least one year from the grant date. If, however, the employee terminates employment before his or her rights to the stock are vested, and as a result the stock is forfeited, then the employee will not be entitled to receive any deduction as a result of the forfeiture.

- Stock Appreciation Rights (“SARs”). A SAR entitles the holder to a payment equal to the amount by which the share value of the company’s stock has appreciated from a specified starting level (usually the value as of the grant date) to the date on which the SAR is exercised. While a SAR is usually payable in cash, it also may be payable in shares of stock. The employee generally becomes entitled to receive payment upon a specified event (e.g., a change in control or sale of the company) or a specified time. Generally, an employee will be taxed on the full amount received upon the exercise, at ordinary income tax rates, and the company will be entitled to a corresponding tax deduction.
- Phantom Stock. Phantom stock awards are based on units that are equivalent in value to actual shares of stock or some other stated measure, as opposed to merely the appreciation in value of a share (as with an SAR). Sometimes the Phantom Stock awards are payable in cash in lieu of stock, or are payable in cash and stock at the company's option. Similar to an SAR award, the employee generally becomes entitled to receive payment of the Phantom Stock award upon a specified event or at a specified time. The employee will not be taxed on his or her award until the units are converted to actual cash or shares of stock. Whether he or she receives cash or stock, the employee will be taxed at ordinary income tax rates on the FMV of the amounts he or she receives, and the company will receive a corresponding tax deduction.

## ***WHY USE EFFECTIVE KEY EMPLOYEE COMPENSATION PROGRAMS***

### **Employee Retention**

One way to improve the chances of retaining key personnel is to create financial incentives that encourage the key personnel to stay. The financial incentive can be created by delayed “vesting” of benefits. For example, a plan might provide that, for every year of service, the employee is entitled to a benefit equal to a percentage of compensation (e.g., 5%) that is vested over a period of years of service (e.g., 20% vested after each year of service until he or she is completely vested after five years). The lengthier the vesting schedule, the greater the financial cost to the employee of

resigning and going to work for the competition, particularly if the vesting schedule is pegged to a potential exit (e.g., sale or initial public offering of the company or retirement).

A vesting structure that has become popular is rolling vesting, under which each annual contribution is vested over a specified period of time (typically three or five years). The thought is that the vesting period is short enough to provide a current incentive for the employee to perform well, but still acts as a retention tool because resignation at any given time will cause the employee to forfeit a portion of each recent contribution.

An employer also could structure a program so that the key employee must work until retirement age (or any other age) or a specified event to receive any benefits. Alternatively, the program could provide that the employee receives no benefits if he resigns or is terminated for "cause" before attaining a specific age or event.

### **Employer Protection: Enforcing Non-Compete Covenants & Confidentiality Agreements**

Most employers have trade secrets, know-how, customer lists, and various other proprietary information that they wish to retain as confidential since disclosure would provide significant benefit to competitors. In addition, key employees may have developed important customer or supplier relationships.

An initial step to protecting confidentiality is for employers to enter into covenants not to compete and confidentiality agreements with key employees. These agreements normally will provide that if the employee violates the terms, the company is entitled to obtain injunctive relief in addition to monetary damages. However, non-compete agreements are difficult to enforce and in some states, like California, are unenforceable.

That said such agreements are often given more weight when an employee has received some type of consideration to sign the agreement, like the benefit of a key employee compensation program. Thus, given the uncertainty around non-compete covenants and confidentiality provisions in employment agreements, an employer may want to use a compensation program to bolster their enforcement.

Accordingly, an employer's compensation program may provide that the employee will immediately forfeit any right to any future benefits under the program if he engages in any competitive activity, regardless of when or where the competitive activity takes place. This program requirement should create a financial incentive for the employee to refrain from such activity.

## Retirement/Ownership Transition: Succession Planning

Many private employers not only need to retain key personnel for current operational success, but also to avoid an ownership vacuum when the owner(s) wish to retire. A compensation program can be designed to retain key people by transferring ownership interests to a (younger) management team in preparation for owner succession.

### **DEVELOPING A PROGRAM**

Employers may conduct their own investigations through trade associations and the internet, or engage consultants to assist with program design that will best align the economics of the organization with its objectives. These consultants have access to market and industry information not readily available to employers. Companies also should involve in the analysis their chief financial officer and outside advisors, including life insurance advisors, as life insurance can provide an effective informal funding tool for long-term incentive programs.

### **LIFE INSURANCE & KEY EMPLOYEE COMPENSATION PROGRAMS**

As noted, an employer can buy life insurance to help meet its future obligations under a key employee compensation plan. The life insurance generally should insure only members of a select group of key personnel or management, although the value or benefits of the life insurance should not be directly tied to the amount of benefits payable under the plan. The company may choose to acquire the insurance coverage through a grantor “rabbi” trust structure, which can provide some security for the future payment of key employee compensation benefits in the event there is a future change in management or control of the employer (note that these trusts cannot protect against losses due to an employer’s insolvency, as the assets must remain available to claims of the employers’ general creditors. See *WR No. 2013-34* for a further discussion of rabbi trusts).

When using life insurance to informally fund a key employee compensation plan, under longstanding and appropriate tax principles, neither the accrual of the policy cash value nor the death benefit paid to the employer should be taxable to the employer (assuming compliance with the employer-owned life insurance requirements under Code §101(j); see *WR No. 2012-24* for a discussion of these issues). The life insurance can also provide the employer with the opportunity to receive reimbursement for part or all of the costs of the plan – the plan benefits and insurance premiums paid.

## **TAKE AWAYS**

- Key employee compensation programs provide several benefits to employers and employees, including incentives for recruitment and retention, a vehicle for enforcing non-compete and confidentiality covenants, and opportunities for retirement and business succession planning.
- When consulting with employer-clients on key employee compensation matters, advisors can provide value by helping to ensure that the economics of the benefit and the company's objectives align.
- Companies should evaluate which program best suits their needs by including the chief financial officer and their outside advisors.
- Life insurance also should be reviewed, as it can serve as a great informal financing for implementation of long-term incentive programs.

## **DISCLAIMER**

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