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Re-aligning incentive compensation strategy in a downturn

If "necessity is the mother of invention", then the current business environment is the time to rethink routine business operations, including long-term incentive compensation strategy. Many organizations are thinking differently as they look to balance the need to conserve or generate cash and manage share usage and dilution levels while, at the same time, continuing to incentivize and retain key talent.

We have presented below five equity compensation strategies which could provide companies the flexibility to pull some immediately available levers to re-align their global incentive compensation strategy with current critical organization-wide priorities during a depressed, volatile market.

These planning opportunities are principally focused on a broad-based employee population and special consideration should be given to executive compensation particularly as each of these planning opportunities has many elements which must be considered. The elements to be thought through range from corporate governance, HR strategy and compensation philosophy and talent objectives to legal and regulatory impact. Further, careful review will need to be given to individual tax and payroll implications, finance and accounting consequences as well as the optics of making changes to the global incentive compensation strategy in the current market. As such, these equity compensation strategies should be reviewed holistically with professional advisors and relevant stakeholders to determine their tax, legal and accounting viability for your company before taking action.

In addition, the impact for plan participants will need to be carefully weighed, and the communications aspects should be thoughtfully managed in these times where many internal employee communications have ramped up significantly.

Accelerate vesting of outstanding equity awards

While accelerating vesting (and share delivery) in the normal course of business could be viewed as contradicting the retentive purpose of equity awards, in an uncertain labor landscape, accelerating unvested awards to the second quarter of calendar year 2020 could lead to several potential benefits.

By accelerating the taxable event to this quarter, companies can respond to take advantage of depressed market prices which would mean that the taxable value of the outstanding equity awards for purposes of both employee-paid taxes and employer-paid taxes could well be lower than it otherwise would have been under the original vesting schedule.

In addition, for those employers who net share settle equity awards and fund the associated tax withholding using available cash reserves, the smaller tax withholding liability would mean a smaller cash outflow now (to pay the income and social taxes) relative to what may be expected later in 2020 or in 2021.

Accelerating the vesting and expediting the transfer of shares to employees gives the employees the ability to choose to sell those shares right away to generate cash or hold the shares to benefit from any future market appreciation with an earlier start to their long-term capital gains period (in other words, providing cash flow options to employees, without using cash). However, particular consideration should be given to whether the plan under which the awards were granted is compliant with Section 409A[1] or 409A exempt in the US Any acceleration or change to an award must be carefully considered in order to avoid any potential failures to comply with Section 409A, as well as the timing of corporate tax deductions.

Further, under the recently enacted Coronavirus Aid, Relief, and Economic Security Act (CARES Act), companies will have the ability to defer the payment of employer Old Age Survivors and Disability Insurance (OASDI) payments for any taxable events triggered after March 27, 2020.

Balancing short-term and long-term objectives is key here and thought will need to be given to which awards and/or how much value to accelerate such that the remaining value of unvested awards, and associated retention incentive "hooks," continue to be meaningful. When the labor market eventually strengthens, vesting schedules may assume a more prominent role again in employee retention.

Shift to non-cash compensation

Companies looking to generate immediate cash savings could consider converting either a portion of an employee's future salary payments or their planned bonus/salary increase into stock-based pay or reducing salaries in exchange for an equity award. In addition to providing cash savings for the employer, payment in stock would present employees with the potential opportunity to benefit from any future market appreciation, and provide alignment with shareholder interests.

Of course, the issuance of shares to replace cash compensation will have an impact on share "burn" rate and possibly dilution (depending on relative number of shares issued) and this should be balanced against the need to preserve cash and in the wider context of talent strategy.

Pay out cash-based long-term incentive awards in stock

Cash-based incentive compensation strategies may require companies to dip into valuable cash reserves to settle vested awards. Settling traditionally cash-based awards (such as cash-settled phantom units) in stock instead of cash may provide companies with a potential opportunity to generate cash savings while simultaneously delivering value to employees in the form of shares, which they can either sell to generate cash on the open market or choose to hold and benefit from any future stock price appreciation.

Additionally, delivery in shares may reduce employee and employer tax liabilities in jurisdictions outside of the US potentially increasing the cash-savings impact of shifting to stock-settled awards for employers. Similar to the potential shift of salary to stock, the settlement of long-term cash incentives in stock may also have an unplanned dilutive impact on shareholders.

Evaluate alternative award types, such as stock options and restricted stock

Organizations suffering from the current depressed economic and labor environment may have an opportunity to broaden their equity compensation strategies. The most prevalent stock compensation vehicle used by multinationals today, for most levels within an organization, is Restricted Stock Units ("RSUs"). However, alternatives to traditional RSU programs such as stock options or restricted stock (as opposed to stock units) can present additional tax planning considerations for employers and employees in the US and overseas.

Stock option programs enable employees to avail themselves of preferential tax treatment in certain jurisdictions e.g., via an Incentive Stock Option plan in the US or a Company Share Option Plan in the UK to mention just a couple of examples. This preferential tax treatment, combined with the ability to issue options with a relatively low strike price using current fair market value at grant (relative to market highs in prior years), could enable companies to deliver equal or additional value to employees at a lower cost when compared with traditional RSU programs.

Restricted stock award ("RSA") programs also present companies and employees with tax-planning considerations. In a number of countries RSAs are taxable at grant, either by statute or by employee election (e.g., in the United States and the United Kingdom an election can be made to be taxed at grant rather than at vesting). With the taxable event arising at grant in these cases, employees may be able to respond to the currently depressed market prices by locking in income and Social Security taxation at grant at a relatively low stock price, which may benefit them in the long run if stock prices rebound and more appreciation is taxed at possibly preferential capital gains rates.

Allowing employees the choice of options or restricted stock/RSUs, or a mix of both, may also be worth considering based on the financial sophistication of your workforce; this approach would also align with the trend toward more employee involvement in the design of their rewards package.

[1] Section 409A of the Internal Revenue Code provides that nonqualified deferred compensation must comply with restrictions on the timing of elections and distributions, or fit under an exception. Failure to comply with section 409A requirements can result in significant federal income tax consequences, including additional Federal income tax imposed on an individual and the assessment of interest and penalties for both an employee and employer.

Consider an alternative tax withholding method

Companies that currently utilize net share settlement procedures for equity award tax withholding and have a need for additional cash could consider shifting to a "sell to cover" arrangement whereby some of the stock underlying the equity award is sold to cover the withholding tax. Such a change would obviate the need for the company to use its own cash to satisfy the tax withholding obligations.

There is no **one-size-fits-all** solution to the challenges presented by a depressed market. However, as we have suggested above, there are numerous ways to plan for short-term needs without losing sight of long-term goals. Now is the time to revisit your long-term equity compensation strategy.

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