COMPENSATION & BENEFITS DIGEST

March 15, 2019 | Volume XXVII, Issue III

IN THIS ISSUE

The Current Mix of Long-Term Incentive Plan Awards

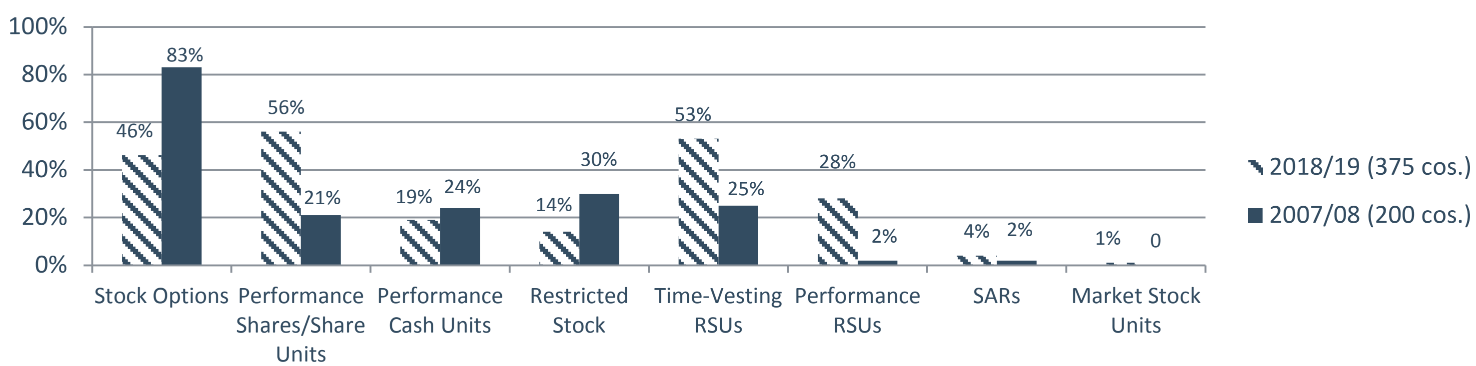
Long-term incentive (LTI) awards continue to represent a significant portion of the compensation paid to senior corporate executives. What has changed is the types and mix of LTI awards made by employers over the past decade. We recently reviewed the LTI award practices of 375 companies where Ayco provides services, updating similar studies conducted two, four and just over ten years ago.

Data is derived from information we maintain regarding LTI grants to executives at client companies, as well as disclosures made in 2018/2019 proxy statements. We specifically focus on the different types of equity and cash-based long-term incentives now being awarded (excluding special awards and retention grants). Many companies provide a different allocation of awards to executives at different levels. For example, prior to the 2017 tax law changes, Named Executive Officers (NEOs) including the CEO, were more likely to receive awards that qualify for the performance exception under IRC §162(m). That exception is now gone and whether this will lead to a change in the mix remains to be seen. While some companies make LTI awards to a wide range of employees, for purposes of this analysis, we will focus on the awards made to senior executives at the companies in our survey group.

➢ Changes in the Mix of LTI Awards

A generation ago, stock options were the primary LTI awards granted to executives. Part of the reason was the more favorable accounting treatment that stock options enjoyed over full-value awards, at least until accounting changes that took place in 2004. Since then, we have seen a rejuvenation of full-value awards - restricted stock and restricted stock units (RSUs), which are generally perceived as less risky than stock options during periods of market turmoil. More recently, we have seen the significant expansion of performance-based awards, including performance units, performance shares or share units and performance RSUs.

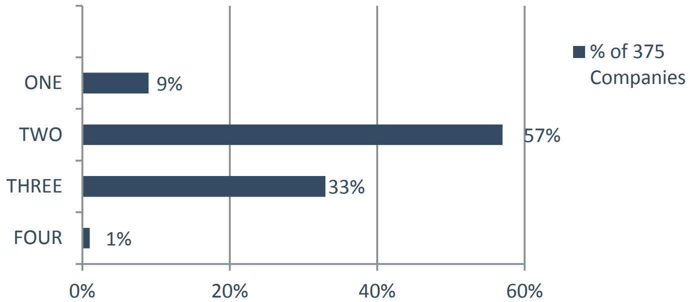
Here are the different types of awards made to eligible executives within the past 12-18 months with an indication as to how the mix has changed over the past decade:



AYCO
A GOLDMAN SACHS COMPANY

➢ Number of Different LTI Awards

The days of a single LTI award are long gone at a large majority of companies. This makes corporate communications more challenging as it is usually necessary to provide an explanation comparing features of awards. This chart illustrates the number of different types of long-term award vehicles granted to senior executives in our survey group within the past 18 months:



➢ Performance-Based Awards Now Are Predominant

The shift in types and number of annual LTI awards over the past 10-15 years likely is due to a number of factors. A major factor has been the influence of corporate governance organizations, specifically Institutional Shareholder Services (ISS) and Glass Lewis. Their metrics strongly encouraged public companies to “pay for performance.” This primarily shifted LTI awards granted to senior executives into more performance-based alternatives - with stock price performance alone not being viewed as sufficient. In addition, monitoring what peers are offering has pushed companies into a more performance-based mosaic. We’re primarily talking about performance shares or share units, performance cash units and performance RSUs.

Over 90% of our survey group recently granted one or more of these performance-based awards to senior executives. These types of awards now make up the largest percentage of LTI awards among our survey group. Here’s what we found in our latest analysis:

Performance-Based Awards (as % of total LTI)	Percent Today
None	7%
10%-25%	6%
30%-35%	11%
40%-45%	5%
50%	37%
60%-85%	26%
100%	8%

➢ Stock Options Are Slipping, But Still Popular

Stock options remain a popular LTI award, although significantly less so than ten or even five years ago. We now count less than one-half (46%) of the survey group granting nonqualified and/or incentive stock options (ISOs) to key executives. Three companies recently granted performance stock options and two awarded premium options to senior executives. In addition, around 4% of the survey group (including most foreign companies) utilize stock appreciation rights (SARs) rather than stock options. Stock options might be considered a "pay for performance" compensation device, but only if stock price increase alone is the performance measure. Stock market volatility illustrates the risk associated with an award tied exclusively to share price appreciation.

Here is the percentage of the total LTI made up of stock options or SARs currently among our survey group, compared to just over ten years ago:

Stock Options and SARs (as % of total LTI)	Percent Today	Percent 2007/08
None	52%	25%
10% - 25%	14%	2%
30% - 35%	16%	10%
40% - 45%	7%	10%
50%	10%	30%
60% - 85%	1%	18%
100%	>1%	5%

For more details as to the structure and design of stock options being granted currently (including types of options, when options are granted, vesting schedules, and periods to exercise following certain events) see our May 2018 *Digest*.

➢ Tax Issues to Consider

Restricted stock units are now being utilized by many more companies than their economic equivalent - restricted stock. While the value can be similar or the same, there are a number of important differences. For example, an §83(b) election can usually be made for restricted stock allowing appreciation following grant to be eligible for capital gains treatment. This election cannot be made for RSUs. This election also then changes the tax treatment of any dividends received prior to restricted stock vesting.

While ISOs can lead to capital gains treatment on the spread, in contrast to NQ options, ISOs are now granted sparingly among our survey group.

The timing of income and FICA taxation can differ for each award. Both taxes are due at vesting for restricted stock (assuming no §83(b) election is made), and upon exercise of NQ option. In contrast, RSUs are subject to FICA at vesting, but income tax only when distributed. A number of companies distribute RSUs in the year after vesting. ISOs also can have a difference in timing, unless there is a disqualifying disposition.

At many companies, time-vested RSUs are designed to vest after a specified number of years or upon retirement eligibility, if earlier. This can mean that FICA taxes are due at the retirement eligibility threshold, while income taxes are not due until payment is made.

Finally, restricted stock is not considered deferred compensation subject to IRC §409. In contrast, RSUs are generally subject to §409A rules. This means that payment to specified employees following a separation from service may be delayed by six months to avoid any potential 20% penalty. Performance awards may or may not be subject to §409A, depending on a number of factors. However, the payment of performance shares, share units, and performance units could meet the short-term deferral exception to §409A, assuming they are paid within 2½ months of the end of the performance period.

The IRS Office of Chief Counsel has confirmed that if an employer recognizes that a plan or agreement is not in compliance with §409A rules and makes a correction prior to vesting, the 20% penalty tax may still be payable (CCA 201518013). Here, an agreement had a 3-year vesting period and subsequent two-year payment period, but the company had discretion to pay the award in a lump sum. This violates §409A rules by allowing for an acceleration in payment. The company corrected the agreement, but the IRS stated that the executive still was subject to the penalty when the correction was made.

- **Can ERISA Apply?**

Generally, no. However, certain broad-based stock compensation programs can be subject to ERISA. If a plan operates similar to a bonus program where awards become payable at various times or events, it could be subject to ERISA eligibility, vesting and fiduciary rules. This would not be the expectation of a corporate sponsor, which is why most LTI programs are limited to executives - making them the equivalent of a “top-hat” plan. In fact, some employers make the one-time filing with the Dept. of Labor confirming that the plan complies with ERISA provisions for which there is no exemption.

- **Equity Choice Programs**

These programs offer eligible executives a choice as to which LTI award they would like to receive - most commonly a choice between NQ stock options and restricted stock or RSUs. These programs blossomed more than a decade ago when we counted 25 companies offering executives a choice as to their LTI award. Due to a number of issues, including having to communicate and explain the differences, as well as the proliferation of performance-based awards (which can be much more difficult to value), and potential §409A timing issues if RSUs were offered, we have seen equity choice programs decrease in utilization. But, we currently see them in place at a dozen companies in our survey group and they remain popular with executives. In a few cases, NEOs are not eligible for a choice election. If you'd like to receive a summary of the design and communications for an equity choice program, contact us at Ayco C&B Digest.

- **Proxy Advisory Firms**

Companies seeking shareholder approval for a new LTI plan or an amendment to an existing plan will need to keep in mind the positions of proxy advisory firms, including ISS and Glass Lewis. Based on plan features, ISS either will recommend shareholders vote “for” or “against” the plan. However, certain egregious plan features could, in and of themselves, lead to a “no” recommendation. These include: (1) too liberal change-in-control definition (single trigger) for accelerated vesting of awards; (2) permitting the repricing or cash buyout of underwater options; (3) pay-for-performance misalignment; (4) any other feature deemed detrimental to shareholder interests, including a reload stock option feature or any tax gross-up.

ISS recently released its 2019 Pay-for-Performance methodology. It consists of both a quantitative and a qualitative review of executive pay and company performance. ISS has addressed front-loaded awards (i.e., a large grant of equity to a new key executive) and indicated it is unlikely to support grants covering more than four years.

In its recent annual update of frequently asked questions on compensation policies, ISS indicated that while shifts away from performance-based pay to discretionary or fixed pay elements after the changes made in IRC §162(m) are not likely to result in an adverse recommendation, ISS would still consider such a change a problematic pay practice and would view it negatively.

- **Methods of Describing LTI for Proxy Reporting**

Some companies report in their proxy statements the value of LTI awards as "realizable pay." This is a supplement to the value of equity awards reported in the Summary Compensation Table (SCT), which generally will be the "fair value" as of the grant date. Realizable pay replaces this value with an intrinsic value as of a defined date - such as year-end - based on the stock price as of that date. Thus, realizable value for a stock option is the "spread" as of a defined measurement date, rather than a projected future value. For restricted stock and RSUs, this usually is the value at the scheduled vesting date. For performance awards it is the target value at the end of the performance period, as opposed to the grant date fair value in the SCT.

Tally sheets are used by Compensation Committees at some companies to illustrate various components of compensation paid to each named NEO. These summarize the number and value of all LTI awards, as well as the current value of benefit and compensation plans as of a stated date, plus what would be payable at retirement, other termination or upon a change-in-control of the company. This can be used to compare and align total compensation paid to top executives with market data or for peer group comparisons.

The SEC has provided guidance as to the proper proxy reporting for equity awards granted to a NEO who is retirement eligible and where the award would become vested at the earlier of the executive's actual retirement or the normal vesting date. In this situation, the SEC confirmed that the company should disregard any retirement acceleration vesting provision and report the value of the award in the compensation tables based on its "normal" vesting schedule, along with a footnote or other supplemental disclosure describing the acceleration in vesting.

The SEC also clarified that when a RSU has become vested, but payment to a "specified employee" is delayed for six months following retirement or other separation from service to ensure compliance with IRC §409A, it would be permissible to report in the proxy the value of the award for the year in which vesting occurs, even if the actual payment (and the year of income taxation) could be the following year.

Should You Be Taxing Employees on Meals and Snacks?

The IRS recently released a lengthy Technical Advice Memorandum (TAM) discussing whether the value of meals and snacks provided to employees should be includible in the employee's income; and if so, how to determine that value (TAM 201903017). The tax treatment of meals provided to employees has not been an issue that the IRS has focused on for some time. Five years ago, the Treasury Dept. did indicate in its Priority Guidance Plan that employer-provided meals would be one of its future priority projects. Now, the chickens have come home to roost.

The unnamed company that was the basis of this guidance provided meals to all its employees, as well as contractors and visitors without charge, and without distinction as to an employee's position or job duties. At some offices of the employer, the meals were consumed in a cafeteria, while at others they could be consumed in snack areas or at an employee's desk. The company also provided unlimited snacks and drinks in designated snack areas. Each of the snack areas had mini-refrigerators, microwaves, toasters and coffee machines (sound familiar to you?).

The company did not have a specific written policy as to the length of a meal period for salaried employees, but hourly employees were allowed 30 minutes for any meal break. There was no corporate policy requiring employees to continuously remain in their office during working hours, although certain security personnel routinely did remain in the office because their jobs generally required continual monitoring of projects.

The employer in question did not impute income to its employees for the meals and snacks provided. Under IRC §119, the value of meals furnished by or on behalf of an employer may be excluded from income if furnished on the employer's business premise for the convenience of the employer. IRS regulations state that the question as to whether meals are furnished for the convenience of the employer is to be determined by an analysis of all the facts and circumstances in each case. Meals can be regarded as furnished for the convenience of the employer if they are provided for a "substantial non-compensatory business reason." Thus, there must be a business nexus between the meals and performance of duties.

The employer in question offered the following reasons to the IRS as to why it provided meals and snacks:

- To foster collaboration and innovation by encouraging employees to remain in the office;
- To protect confidential and proprietary information by providing a secure environment for business discussions;
- To protect employees due to unsafe conditions surrounding certain offices of the employer;
- To provide healthy eating options to help improve employee health;
- Because some employees cannot obtain a meal within a reasonable period;
- Because the demands of certain employees jobs allow them to take only a short meal break;
- To provide meals for employees who may need to handle emergencies that could regularly occur.

The company argued that these justified not taxing employees on the value of meals. They also argued that the value of snacks provided qualified as a de minimis fringe benefit excludible from income under IRC §132(e). However, the IRS largely rejected the employer's arguments regarding meals, generally because the employer failed to have specific policies in place or substantiate that providing meals helped achieve the stated goals. In addition, a proliferation of meal delivery services currently available in most locations is now problematic in justifying that the value of meals provided are tax-free.

The IRS stated in the memo that if employees have a variety of meal options that can be delivered to their place of work with just a phone call or through a website, then the argument that an employee cannot obtain a meal within a reasonable period would not be met. But, the IRS did indicate that meals provided to employees who regularly are on call for emergencies could possibly be excluded from their income. However, the employer did not provide enough specifics about which employees met this requirement.

Based on the information provided, the employer had not demonstrated that at least half of all employees were furnished meals for the convenience of the employer, a requirement for the exclusion under IRC §119. In addition, the snack areas and employee desks where some employees ate meals did not qualify as eating facilities under IRC §132.

Snacks - Snacks are not meals (as your mother may have told you) and the IRS agrees. Therefore, they cannot qualify as meals provided for the convenience of the employer. However, the IRS did indicate that the value of snacks provided could be excludible from income as a de minimis fringe benefit. Quantifying the value consumed by each employee would be administratively impracticable given the generally low value of each snack portion.

Valuation - For meals furnished by an employer that do not qualify for an exclusion from income under IRC §119 or §132, employers should include in each employee's income the amount by which the fair market value of the meals provided exceeds the amount, if any, paid for the meals by employees. Valuation of such meals can be a challenge. Treasury regulations do have an alternate valuation rule for meals provided at an employer eating facility that can be used to value meals. It sets the value at 150% of the "direct operating costs" of the eating facility. In this fact pattern, the employer did not charge employees for their meals. As a result, it must allocate the entire total meal value (i.e., 150% of direct operating costs) to its employees in a reasonable manner, according to the IRS.

Tax reporting - The value of the free meals provided by the employer should be imputed into each employee's income, possibly with an exception for employees who are on call for emergencies. This would be reported on an employee's Form W-2 and also are considered "wages" for FICA tax purposes. An employer would also need to substantiate which employees' salaries exceeded the Social Security wage base (so that additional amounts imputed for meals would not be subject to Social Security taxes) and which employees' compensation could lead to reporting for the Additional Medicare Tax.

Recent tax reform changes now limit an employer's tax deduction for meals that qualify under IRC §119 to 50% of the value reported through the end of year 2025.

If you are providing meals and/or snacks to your employees, you will want to have your tax professionals review this lengthy IRS memo (50 pages) - maybe with a snack nearby. It should be noted that a TAM is not binding on other taxpayers, but does reflect the IRS position on this issue.

Federal Income Tax Withholding - Recent Developments

Mandatory income tax withholding on wages initially was put in place after the federal income tax was enacted in 1913. However, complaints and criticism by employers led to the repeal of required tax withholding in 1917. When the Social Security Act was passed in the 1930s, it was funded through mandatory payroll tax withholding by employers. During World War II, the financial burdens of the government collecting personal income taxes led to the enactment of the Current Tax Payment Act in 1943, which brought back payroll tax withholding and added quarterly tax payments. The federal tax withholding amount is based on the amount of an employee's wages less an amount for withholding allowances claimed by the employee on a Form W-4. Federal withholding amounts are at graduated rates based on percentage method withholding tables based on filing status, up to a certain maximum amount, and then a stated formula.

In contrast to the table-based rate for regular wages (i.e., salary), a flat federal tax withholding rate applies to other employment related income, characterized as supplemental wages. This includes such compensation as bonus payments, commissions, vacation pay, meals, overtime payments, severance, payments of nonqualified deferred compensation and taxable long-term incentive compensation awards.

Any increase or decrease in federal tax rates which is enacted by Congress can lead to a change in the tax withholding rates for both regular and supplemental wages. This can result in confusion both for those responsible for payroll withholding as well as employees filing tax returns.

The Tax Cuts & Jobs Act of 2017 did reduce federal tax rates beginning in 2018, and as might be assumed, federal tax withholding rates were adjusted. The flat rate on supplemental wages was reduced to 22% (from 25%) or 37% (from 39.6%) when aggregate supplemental wages reach $1M through 2025. In addition, the federal tax withholding tables were adjusted downward last February to reflect the lower tax rates. But, this has led to confusion by many who did not recognize that a slight increase in their paycheck could lead to less of an expected tax refund for 2018 tax filings.

W-4 Changes - The IRS proposed making changes in Form W-4 withholding to reflect the lower tax rates. For 2019, one withholding allowance is calculated at $4,200. Originally planned for use in 2019, the IRS decided to delay implementation of a revised Form W-4 based on concerns raised by payroll and service providers that it would be difficult to have a new form and structure in place for use this year. According to the President of the National Reporting Consortium, payroll administrators need at least six months to revamp their withholding systems. Based on common sense suggestions, the IRS agreed to delay changes in the Form W-4. They now expect to issue a revised Form W-4 in the next few months for use in 2020.

Private Company Equity - Another tax withholding issue for private companies relates to how and when federal taxes are withheld upon the exercise of stock options or the settlement of a RSU under new IRC §83(i). This was added by the 2017 tax law change and allows deferral of the taxation of stock in a private company for up to five years, conditioned on the company having a written plan under which not less than 80% of the company's employees are granted the stock rights. In Notice 2018-97, the IRS confirmed that the federal withholding rate on such stock would be the highest marginal tax rate (37% in 2019). The tax withholding is to be paid on the date that the stock becomes taxable. However, the tax will be determined based on the value of the stock on the date of vesting rather than on the tax date, which could be five years after the vesting date. This would be true even if the value of the stock declines during the five year period or even if the private company goes bankrupt or out of business. In addition, the Notice indicates that an employee must agree that all the shares of stock covered by a §83(i) election will be held in an escrow arrangement. The employer may then remove from the escrow shares having a market value equal to the income withholding taxes that the employee has not paid through other means. Private companies that decide to take advantage of this opportunity will need to review this notice and establish appropriate tax withholding policies.

State Laws/ERISA Preemption - The Department of Labor (DOL) recently issued an Information Letter confirming that any state law which requires an employee's written consent before amounts are to be withheld from an employee's wages relating to an ERISA plan are preempted by federal law. A request was made by the American Council of Life Insurers about an arrangement in which employees were automatically enrolled in disability coverage with an automatic deduction from wages for plan contributions, unless an employee elected not to participate. Several states have enacted laws that require written consent by an employee with regard to wage withholding. The DOL confirmed that ERISA preemption applies in this situation since it relates to a benefit that is subject to ERISA.

Is Share Withholding a §16 Violation? - Section 16(b) of the Securities Exchange Act requires executive officers, directors, and 10% shareholders to repay to the company or a shareholder any "short-swing profits." These can occur when there is a "matchable" non-exempt purchase and sale of company stock within a period of six months. A single individual has been seeking recovery from several companies in ten different states for what he has argued are short-swing violations when an executive or director elects share withholding following the exercise of a NQ stock option or the vesting of restricted stock. While the exercise of a NQSO is a reportable and matchable purchase, share withholding by the company generally will be an exempt transaction where the plan authorizing this action has been approved by shareholders or in certain other situations (i.e., board approval).

The individual who has brought multiple lawsuits has argued that where the plan or grant agreement allows the company discretion to permit share withholding (as opposed to mandatory share withholding), each decision would require approval by the full board of directors or a committee composed solely of two or more non-employees.

Recently, the 10th Cir. Ct. of Appeals rejected this argument (*Olagues vs. Muncrief/WPX Energy*), the same result as a decision by another federal court last year. The courts had uniformly held that a share withholding election authorized under a plan approved by shareholder meets a Rule 16b-3 exemption. However, some are now suggesting companies review the terms of their share withholding provisions to possibly remove company discretion.

When Employers May Recover Mistaken HSA Contributions

Health savings accounts (HSAs) have now been around for nearly 15 years. An estimated 25 million Americans had a HSA as of the end of 2018, according to Devenir, and HSAs hold nearly $54 billion in assets. Most employers that offer high deductible health plans have a recommended or required HSA administrator for employee accounts and for any company match or other contributions. However, an employee can also create and fund a separate HSA (subject to the overall contribution limits).

There can be situations in which contributions made by either an employee or employer were made in error - for example, when an employee was not eligible to contribute to the HSA or an excess amount was contributed. Just over ten years ago, the IRS issued its initial guidance clarifying certain limited situations in which an employer may recover improper contributions made to an employee's HSA (Notice 2008-59). Since then, many more employees have participated in HSAs - and there have been many more situations in which unintended mistakes have been made. Recently, the IRS issued additional guidance clarifying when an employer may recoup mistaken HSA contributions (Information Letter 2018-0033).

The IRS confirmed in this guidance that Notice 2008-59 does not specifically address all situations in which mistaken contributions were made to an employee's HSA and can be corrected. These could include processing errors or recordkeeping mistakes made by the employer or HSA administrator. The recent information letter provides examples of the types of errors which may be corrected without a violation of the rules, including:

- An amount withheld and deposited in an employee's HSA that is greater than the amount shown in the employee's HSA election;
- An amount deposited in an employee's HSA that the employer did not intend to contribute, but was due to an incorrect spreadsheet or because employees with similar names were confused with each other;
- An error made by the payroll administrator which caused an incorrect amount to be withheld from the employee's pay and contributed to the HSA;
- An incorrect amount contributed because the payroll election was not processed timely;
- An amount deposited in an employee's HSA that is incorrect because a decimal position is set incorrectly resulting in a greater contribution than intended.

The IRS has indicated that employers should maintain documentation to support claims that a mistaken contribution occurred and then can be recovered properly.

Ayco's 2019 Executive Benefit Survey Still Open – But Not for Long

We invite you to participate in our 2019 survey of select executive and broad-based benefits. An interactive 2019 Executive Benefit Survey form included in the email of this month's edition.

We are hoping to receive all responses by April 15th. All companies or entities that participate in this survey will receive complimentary copies of the survey results when published, likely in June.

Did You Know…?

- One of the first companies to issue stock options to a broad group of key employees was Pfizer in 1952.

- Just under 60% of HSA contributions came from employees in 2018 - with an average employee contribution of $1,872 - while just over one-quarter of contributions were made by an employer - with an average contribution in 2018 of $839 - and the remainder being from a separate individual contribution not associated with an employer, according to the Devenir Research 2018 Year-End HSA Statistics & Trends Report.

- The IRS recently reduced the threshold for avoiding potential underwithholding estimated tax payment penalties for the 2018 tax year. Instead of 90% of 2018 taxes owed threshold, it will be reduced to 85% of 2018 taxes (or 100%/110% of 2017 income taxes due). See Notice 2019-11.

The Ayco Company, L.P.
P.O. Box 15201
Albany, New York 12212-5201
Phone
(518) 640-5250
E-mail
Ayco C&B Digest.
Published Monthly

AYCO
A GOLDMAN SACHS COMPANY