



An Executive Compensation Primer For The HR Professional

Insights

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An HR professional wears many hats relative to executive and key employee compensation. This article addresses three primary responsibilities of the HR professional: (1) understanding the core elements of a typical key employee compensation package; (2) understanding the primary duties and roles of the HR professional with respect to the design and administration of incentive packages; and (3) being aware of hot topics impacting the provision of executive compensation.

Typical Executive Compensation Package

A typical executive compensation package consists of five components: base pay; health and retirement benefits; fringe benefits; short-term incentives; and long-term incentives.

Base Pay

Depending on your industry, the size of your organization, your expectations for the executive, and the talents the executive brings to the table, base pay can be completely in line with the natural graduation of the non-executive company pay scale, or be an exaggerated multiple of non-executive pay.

Employee Health And Retirement Benefits

Just like regular employees, your key employees participate in the company's health plans—although it's not uncommon for senior executives to receive employer-paid health benefits for a specified period of time if the executive retires under favorable conditions, or if the business is subject to a change of control. When it comes to insurance, key persons often receive enhanced policies/benefits for disability, AD&D, long-term care, and life. Specifically with respect to retirement plans, many key employees are provided the opportunity to participate in supplemental "nonqualified" retirement plans.

A typical **Nonqualified Deferred Compensation** (NQDC) retirement plan is employee-funded and allows the key employee to defer all or part of their compensation (base and/or bonuses), which often reduces current taxation. Plans are often written so that the amount of the deferrals and future payouts can fluctuate. Interest is often credited to the deferrals. In order to avoid taxation due to constructive receipt, the plan is drafted such that (i) the employee never receives or has the right to receive the benefit; (ii) the employee cannot receive an economic benefit from or otherwise leverage the promised compensation; (iii) the deferred compensation remains a corporate asset and therefore at the risk of creditors; and (iv) the benefits are only obtained upon the satisfaction of set corporate goals.

A **Supplemental Executive Retirement Plan (SERP)** is a type of NQDC plan that is generally employer-funded and provides for retirement benefits “above and beyond” qualified retirement plan limits. The SERP can be customized to allow maximum discretion with respect to eligibility and vesting. A SERP can be a defined contribution or defined benefit arrangement. In a defined contribution SERP, the employer will credit a particular amount to a nonqualified plan based on the key employee’s performance. There are no limits on the amount of the contributions and the contributions grow tax deferred. In a defined benefit SERP, the employer makes a future promise to pay the key executive a specific amount of retirement income, often according to a stated formula, but sometimes as a stated amount. Funding a SERP can be done in many ways, including use of a split-dollar insurance arrangement.

Fringe Benefits And Perks

Key employees often receive a variety of fringe benefits and perks. Common fringe benefits/perks include transportation benefits (corporate cars, first-class or private plan travel, etc.); club membership or dues reimbursement; special housing arrangements; moving expense reimbursements; and extended vacations and/or sabbaticals.

Short-Term Incentives

Many key employees have bonus and annual incentives designed to motivate them to meet more immediate individual and corporate goals. Short-term incentives are most often in the form of cash compensation and are paid out shortly after the end of the year in which they are earned.

Long-Term Incentives

The vast majority of executives also receive long-term incentive compensation. These incentives are often paid with company stock or equity rather than cash and are typically forfeited if the executive terminates employment. The long-term incentive is paid in the future and often over several years. All of these factors combine to incent key employees to make decisions that benefit the company over the long-term. There are five types of individual equity compensation plans:

- • **Stock Options** are the right to purchase a certain number shares at a specific price, set at the time of grant, for a certain number of future years.

Non-Qualified Stock Options—aka “non-statutory stock options” (NQSOs)—provide the holder with the option to purchase stock from a company at a set price at some point in the future. Oftentimes the set price equals the FMV of the stock when the option was granted. The option to purchase at the set price can span the course of several years and sometimes vests in increments. These are attractive to employees in high-growth industries. They can be granted to non-employee directors, consultants, and advisors, and the employer is entitled to a deduction when exercised. There is no limit on the number of NQSOs that can be exercised annually, and no limit to the number of shareholders who can receive NQSOs. However, they come with onerous rules for private companies, and therefore are a much more popular choice for publically traded companies

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Incentive Stock Options – aka “statutory options” (ISOs)—are issued under incentive stock option plans according to IRS regulations. Statutory options must be in writing and provide an employee a right to purchase employer stock at a set price. These regulations subject ISOs to several key restrictions including a \$100,000 limitation on the annual amount of stocks underlying ISOs that can become exercisable by an executive in a calendar year, and special rules when options are granted to more than 10 percent of shareholders. While there is no ordinary income, employment tax, or employment tax withholding on the exercise of ISOs, there are multiple rules and holding periods, and they are only available to employees.

- **Restricted Stock and Restricted Stock Units** allow employees the right to acquire shares by gift or purchase once certain restrictions are met. These restrictions are often tied to performance targets, longevity goals, or other factors supporting key corporate priorities. Restricted Stock may be provided via actual shares or an unsecured promise to deliver shares in the future. An employee could be granted actual shares of stock that are subject to forfeiture or repurchase during a set restricted period. In such a situation, the employee has voting and dividend rights because they are the beneficial owner of the shares. In contrast, Restricted Stock Units represent a commitment to give a specific number of company shares at some point in the future. In these scenarios, the employee is not a stockholder and therefore has no voting or dividend rights. Once the restrictions on the stock lift and the stock vests, the recipient can choose to receive actual shares, and thereby become a shareholder, or receive the equivalent cash value of the shares received.
- **Phantom Stock and Stock Appreciation Rights** are similar—both provide future bonuses equal to the value of a designated number of shares. Phantom stock pays the future bonus in the form of a cash bonus based on the value of a specific number of shares, while stock appreciation rights (SARs) pay the future bonus in cash or shares based on the increased value of the shares. The owner of the SAR does not own any company stock. Unlike options, the employee does not pay the exercise price. These are often granted in tandem with options to finance the purchase of the options or the payment of taxes associated with the option exercise. However, there is no capital gains treatment and there are numerous tax and accounting requirements. Meanwhile, phantom stock is a commitment to replicate owning stock over a certain period of time. The phantom stock owner is not a stockholder but receives a cash bonus equal to the value of a specific number of shares. Unlike SARs, phantom stock may reflect dividends and stock splits. However, valuing equity and strategically allocating awards requires careful planning. Accumulated cash is potentially subject to an excess accumulated earnings tax. If a plan benefits more than key employees and ties benefits to retirement or termination, there is risk that the arrangement will be considered an ERISA plan.
- **Employee Stock Purchase Plans** are company-run programs designed to encourage all employees, not just executives, to purchase company shares at a discounted price. They are typically not offered to persons owning more than 5 percent of company stock.

The main role of the HR professional when it comes to developing executive compensation plans is to understand how incentive compensation is tied to strategic corporate goals and organizational performance. The primary goals may be financial: shareholder return, earnings per share, return on equity, increased market share, etc. Or they could be non-financial in nature: increased quality, customer satisfaction, employee satisfaction, sustainability, productivity, etc.

There are five main steps to undertake in order to fulfill your role in this process:

- • 1. Understand the range of incentive compensation options available and appropriate to meet your organizational goals.
- 2. Be prepared to explain the tax advantages and risks associated with each option from both the corporate and individual perspective.
- 3. Determine what resources are required and needed to successfully design and manage the incentive program.
- 4. Ensure that incentives, particularly CEO compensation, have been and remain thoroughly benchmarked, in order to ensure competitiveness and withstand regulatory, consumer, and political scrutiny—particularly for companies that are publically traded.
- 5. If publically traded, comply with regulations mandating disclosure of compensation. The Securities and Exchange Commission (SEC) requires publically traded companies to disclose the comparison between median employee pay and CEO compensation. Also, ensure your Board of Directors (or Compensation Committee) is appropriately engaged in approving executive compensation packages according to federal regulatory agencies such as the SEC.

Hot Topics In Executive Compensation

Finally, it is critical that you pay attention to recent developments and expected future action when it comes to executive compensation in order to stay on the cutting edge of the field. In early 2019, there are three main developments to tune into:

Diversity And Gender Pay Equity

The #MeToo Movement has revitalized the topic of diversity and gender pay equity, and much proposed legislation is pending. The Dodd-Frank CEO Pay Ratio disclosures, mandated for 2018 proxy filings, are also fueling this issue. Many facets and challenges related to this issue have been explored by the Fisher Phillips Pay Equity Practice Group.

Clawback Options

Several proposed and enacted federal laws recommend or require the return “clawback” of executive compensation when such compensation is earned based on fraud, accounting errors, or the misuse of accounting information. Clawbacks are increasingly popular with public and regulatory agencies, and may take effect whenever there is a need to restate financial performance, regardless of individual executive culpability.

2017 Tax Cuts And Jobs Act

This federal law includes numerous provisions that impact highly compensated individuals, most of which became effective in 2018. A complete summary of the relatively new laws [can be found here](#).

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