Our Biennial Long-Term Performance Plan Review

Performance-based awards have become the most prevalent element of long-term incentives (LTI) provided to executives at most public, and even many private, U.S. companies. The most recent Frederic W. Cook Top 250 Report on the LTI practices among the 250 largest companies in the S&P 500 reported that 55% of the LTI granted to CEOs in 2016 were performance awards. At least part of the rationale for the increased use of performance-based awards are the recommendations of corporate governance monitors like ISS for closer links between executive pay and corporate performance.

We recently updated our own informal survey of 350 companies where Ayco provides financial counseling or financial education services as to their utilization of performance awards and the design of the most recent grants. Our survey reveals that over 85% of this group granted performance awards within the past two years, an increase from the 70% which granted performance awards in a similar informal review we conducted ten years ago. Not only are more companies utilizing performance-based LTI, but the percentage of total LTI has shifted away from time-vested awards toward those that are performance-based (see our March Digest for the current mix of LTI plan awards).

In addition, over one-quarter of our survey group modified the metrics and design of their performance awards within the past three years. Almost all of the companies which do not use performance-based awards grant equity-based LTI awards, including stock options, restricted stock or restricted stock units as long-term compensation, sometimes with performance vesting or other performance features.

➤ Types of Performance Awards

By performance awards, we mean performance units ("PUs"), performance shares or performance share units ("PSUs"). We do not include annual bonus awards, restricted stock or RSUs with performance features – such as accelerating vesting if defined performance metrics are achieved. Performance units typically have a denominated target value (e.g., $100) with payout based on the achievement of one or more performance measures over a defined performance period. Performance shares or PSUs differ from performance units in that their value is typically based on the value of a share of company stock. Performance shares and PSUs may have associated dividend equivalents. This feature is growing, although still remains relatively uncommon among our survey group, with slightly less than 15% providing dividend equivalents.

Performance awards typically are granted under an omnibus LTI plan, but can be granted under a separate plan. One reason to maintain a separate plan is to be able to make awards to a different class than those receiving equity grants. Not only are performance awards designed to reward the achievement of financial measures different from those for equity-based awards, but the performance period often will be shorter than the typical period to exercise stock options and may differ from the vesting period for restricted stock or RSUs. Finally, and of increasing importance these days, performance awards payable in cash do not "use up" authorized shares that companies may need for equity awards. However,
performance awards can be more difficult to communicate to eligibles. This includes estimating the value of any potential payout during the performance period.

**Frequency of Grant**
Whether to make a grant annually or only after a prior cycle ends is an element of plan design. Overwhelmingly, we continue to see most companies - 95% of our survey group, make grants annually. The remaining 5% made subsequent grants after the end of the performance period. To a large extent, the decision over the timing of grants (annually or consecutively) is driven by the performance measures selected. One consequence of annual, overlapping grants is that a particularly poor performance year, or an extremely good year, averages out over the performance period. But a particularly poor year early in a cycle can doom the potential value with consecutive award periods. This is precisely what happened a decade ago during the 2007/08 downturn as we saw numerous companies forced to collapse performance cycles or modify targets.

**Performance Period**
One feature which differentiates these awards from stock options and other equity-based awards is the performance period. Performance is measured over a specified period, with payment typically based on aggregate performance over the entire period. A number of companies “bank” earned amounts for a portion of the performance period. An example at one company is that executives earn a portion of the PSUs awarded for the 2016-2019 cycle at the end of year 2 of the three-year performance period based on the company’s relative total shareholder return (TSR). This interim award is “banked” and paid after the end of the full performance cycle. This allows amounts earned for the partial performance period to be paid regardless of the performance in the final year. A few companies utilize a one-year performance period but with a subsequent vesting period of 2 or 3 years.

Performance periods range from a period of up to five years, with the most common performance period being three years. Our recent survey revealed the following performance periods:

<table>
<thead>
<tr>
<th>Performance Period</th>
<th>Percentage of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>One Year</td>
<td>1%</td>
</tr>
<tr>
<td>Two Years</td>
<td>4%</td>
</tr>
<tr>
<td>Three Years</td>
<td>89%</td>
</tr>
<tr>
<td>Four – Five Years</td>
<td>3%</td>
</tr>
<tr>
<td>Split or Banked Feature</td>
<td>3%</td>
</tr>
</tbody>
</table>

**Performance Measures**
This is the most important element in the design of a long-term performance plan – and what makes these awards more difficult to communicate and measure, especially during the performance period. Approximately 20% of the companies in our survey group use a single performance criteria, while just under 64% use two measures, 12% use three performance measures and 4% use four or more distinct measures.

The following are the primary performance measures we identified. The total will add up to more than 100% because of the multiple performance criteria utilized by a majority of companies.
The TSR Breakdown

Total shareholder return is the stock price appreciation during the defined performance period plus any dividends or other distributions paid during that period. We have seen some companies use a 20-day (or other designated period) average closing price of company stock to determine the stock price appreciation, so that TSR is not dependent on the company’s stock price as of a single date (e.g., December 31).

We also found that many companies compare at least one measure (mostly commonly, TSR) against the performance of a peer group or against a standard index (e.g., the S&P 500) or use both. The use of a peer comparison has increased from what we noted in our past surveys. Here is a breakdown of how the TSR metric was used to determine an award payout.

Maximum Payout

A feature found in most performance awards that differentiates it from stock options and restricted stock/RSUs (even those with performance elements) is an opportunity to realize more than the “target” award. A target award often is expressed as a number of company shares or a dollar amount which would be earned if the target goals are achieved. Typically, a lesser percentage of the full target can be earned if goals are partially met. Plans typically have an expressed minimum when no payout will occur and a maximum if targets are exceeded. We noted several companies which reduced the maximum payout percentage within the past year. There also were four companies with a higher payout maximum for the CEO than other senior executives. Here are the maximum payout amounts indicated under plans for which this was available:

<table>
<thead>
<tr>
<th>Maximum Payout</th>
<th>Percentage Of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>100%-130% of Target</td>
<td>4%</td>
</tr>
<tr>
<td>150% of Target</td>
<td>18%</td>
</tr>
<tr>
<td>160%-175% of Target</td>
<td>1%</td>
</tr>
<tr>
<td>200% of Target</td>
<td>74%</td>
</tr>
<tr>
<td>Above 200% of Target</td>
<td>3%</td>
</tr>
</tbody>
</table>

Distribution Features

If performance targets are met, distribution generally is made in the year following the end of the performance cycle. However, a number of companies have a vesting period following the performance period or stagger payments over two or three years after the performance period. This can act as a retention device, as payout typically is contingent on remaining employed through the vesting or payment date.

Based on plan design, distribution may be in cash, shares of company stock, either cash or stock at company discretion, or partially in cash and partially in stock. Our survey indicates the following forms of payment:

<table>
<thead>
<tr>
<th>Form Of Payment</th>
<th>Percentage Of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>35%</td>
</tr>
<tr>
<td>Shares</td>
<td>50%</td>
</tr>
<tr>
<td>Cash and/or Shares</td>
<td>15%</td>
</tr>
</tbody>
</table>

Under the plans at three companies, payout is in stock up to the target amount and then made in cash if performance is above target; this structure is reversed at another two companies where payout is in cash to target and in stock if performance is above target.

Tax Treatment

Performance awards are income taxable when paid rather than when the performance targets are achieved or the award cycle ends. However, FICA taxes, including the 0.9% Additional Medicare tax, will generally be determined and payable as of the vesting date (subject to the rule of administrative convenience – which allows employers flexibility in when the tax is actually collected and paid).

For federal tax withholding, awards are supplemental wages, subject to the supplemental wage withholding rules, meaning generally the flat rate withholding at 25% - or 39.6% if the tax recipient is over $1M in aggregate supplemental wages. Companies issuing shares of stock often allow for share withholding.

In almost all cases, payment occurs in the first quarter after the end of the performance period, thus avoiding being considered deferred compensation. To qualify for the short-term deferral exception under IRC §409A, awards must be payable generally within 2½ months following the end of the year in which the award is vested and determined.
One of the more challenging tax aspects is any state income tax allocation for an executive who works in more than one state during the performance period. While it is the responsibility of the executive to report properly any allocation among states worked during the performance period, this can be a significant issue for companies if there is a nonresident state tax withholding requirement – as there are for dozens of states.

**Deferral Opportunity**

We found that just under one-third of the surveyed companies permit the deferral of a performance award, subject to §409A rules. Under special timing rules applicable to performance-based awards, a deferral election may be made six months prior to the end of the performance period. Our last informal survey of the design of elective nonqualified deferred compensation plans indicated that fewer companies are utilizing a June deferral window for the deferral of annual bonus and long-term performance plan awards – just over 15% of our survey group (see June 2016 Digest).

**Termination of Employment or CIC**

We looked into whether payment would be made in the event that a participant terminated employment during the performance period. In the event that termination was due to qualified retirement, disability or death, a significant majority of the plans in our survey group provide for a pro-rata distribution at the end of the performance period based on service of the executive during the cycle. The company maintains the discretion to pay a full or partial award in slightly less than 20% of the plans surveyed. In the event of a voluntary termination by the participant, entitlement to payment is forfeited at 95% of the surveyed plans, while at the remaining 5%, a pro-rata award could be payable in the discretion of the company.

In the event of a change-in-control, most of the plans provide for a payment of the target amount without waiting until the end of the performance cycle. While this appears to be equitable considering the circumstances, the accelerated payout without regard to assessing actual performance results means that the payment will generally be considered a parachute payment and become part of the golden parachute excise tax calculation.

**SEC Disclosure**

Both the grant and the payment of performance awards to "named executive officers" (NEOs) are reportable in proxy statements. Under a table for non-equity based awards, the target, threshold and maximum value of the grants is reported. Payouts are reported in the Summary Compensation Table, generally under a column entitled “Non-Equity Incentive Compensation”. The new table illustrating NEO pay relative to TSR performance that may be required as early as next year will increase proxy reporting of pay-for-performance metrics. With the SEC focusing on clearer descriptions of performance criteria, we saw significantly enhanced narrative discussion of performance goals in the Compensation Discussion & Analysis (CD&A) in this year’s proxy statements.

The grant of an award to a §16 insider is not reportable on a Form 4 (unlike the grant of stock options and restricted stock). Awards payable in company stock, such as performance share units, become reportable only when performance conditions have been achieved.

**ISS Pay-for-Performance Assessment**

A new standardized comparison of CEO pay and financial performance ranking relative to the ISS-selected peer group will be added to proxy research reports. Three-year financial performance will be measured by a weighted average of six financial metrics including return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth, and cash flow from operations growth. The metrics and weightings will be based on the company’s four-digit GICS industry group. While this information will not impact the qualitative pay-for-performance tests during the 2017 proxy season, it may be referenced in the qualitative review and therefore, may lessen or amplify pay-for-performance concerns. It is also possible, and highly likely in our view, that the financial metrics will be incorporated in the pay-for-performance tests at some point in the future.

**Recent Adjustments in Performance Award Design**

We have been monitoring the design of long-term performance plans among our survey group for over the past 15 years. Some of the changes we have seen over the past two years include:

- Increase in portion of LTI allocated to performance awards;
- Increase in the number of performance measures;
- Increase in the use of relative total shareholder return as one of the measures;
- Slight decrease in maximum potential payment;
- Increase in share or share unit awards and/or payment in shares of company stock;
- Significant increase in clawback features associated with LTI award.
Conclusion

Performance awards have become a major component of the compensation programs at most large public companies, and are often the major long-term award at companies that do not utilize stock as compensation. They can be designed to reward the achievement of both short-term and long-term strategic objectives, rather than simply share price appreciation, and help to attract and retain key executives. Most companies review the design of their performance awards periodically to ensure they are meeting corporate objectives. This can lead to tweaks or adjustments in performance components – which can necessitate a new or renewed communication to help eligible executives understand the impact of the adjustment. Long-term performance awards unquestionably are now a significant part of a diversified approach to executive compensation in corporate America.

Tax Treatment of Employee Discount Programs

Does your company provide a discount for company merchandise, products, services or other items? If so, you will want to review recent IRS guidance addressing tax consequences of offering such programs. An Office of Chief Counsel Memorandum was issued in response to a request from an unnamed company asking the IRS to confirm the tax treatment of the company’s discount program for employees and certain non-employees. This appears to be the first such guidance in this area, although since it is a general advice memo (as opposed to a formal ruling), it cannot be used or cited as precedent (see OCC Memo 20171202F).

First, let’s review the basic tax rules in this area. In general, under IRC §61(a), the value of a fringe benefit provided to an employee is to be included in W-2 income of the person performing services in connection with the benefit furnished. Thus, there could be tax consequences to an employee even though that person did not actually receive the fringe benefit. In addition, employers must collect and pay employment taxes related to non-cash fringe benefits.

However, there are several “qualified fringe benefits” that can be excludible from an employee’s income under IRC §132. One such excludible fringe benefit is a “qualified employee discount”. This is defined in IRC §132(a)(2) as any employee discount on merchandise, products, or service that does not exceed 20% of the price at which the product or services are being offered by the employer to its customers. If the discount exceeds 20% of the price offered, the excess amount should be includible in the employee’s income. In determining the amount of the discount, the price at which the property or services is being offered to customers at the time of the receipt of the discount is controlling. In addition, the product for which the discount applies must be one provided by the employer in its ordinary course of business.

Who is considered an employee for purposes of this qualified employee discount includes individuals currently employed by the employer, as well as retirees, former employees, those who became disabled while working for that employer, as well as their spouses and dependent children, or a widow or widower. But, only those individuals who meet this definition qualify for an exclusion from income for a qualified employee discount. That became an important distinction in the discount program in question in the most recent IRS memo.

The program that was subject to the IRS guidance allowed employees to designate a certain number of other individuals to receive a percentage discount off of the published rates for the employer’s rental services. In North America, these could be spouses or domestic partners, family members, as well as friends of the employee. The discount could not be combined with any other promotions and was subject to certain commercial blackout dates.

The IRS Chief Counsel memo concludes that while the discount provided to employees and eligible family members could be considered a qualified employee discount and thus, be excludible from income; any discount provided to friends of the employee would result in taxable income to the employee who designated such individual as eligible for the discount. In addition, the employer must then collect employment taxes on the value of the discount.

It is not uncommon for employers – large and small, public and private – to offer a discount for employer products, merchandise, or services to all or certain employees. Those employers offering any such discount to employees or others will want to review this recent guidance. In addition, it may make sense to communicate the tax consequences of the discounts offered to those eligible for them. Approximately 10% of S&P 500 companies disclosed some type of employee discount in their most recently released proxy statement, according to our recent proxy review.
What’s The Maximum Loan Amount That Can Be Taken From a 401(k) Plan?

While a 401(k) plan is not required to permit loans to plan participants, virtually all large company plans do so. A plan document and summary plan description (SPD) also should state the number of loans that may be taken within any defined period. If a plan permits more than one loan to be taken during a 12-month period, it may not always be apparent and easy to determine the allowable amount of a second or third loan. This is due, in part, to the language in Internal Revenue Code (IRC) §72(p) that defines the maximum amount of a permissible plan loan. In fact, the IRS recently issued new guidance to its own auditors as to the computation of a maximum loan amount and the different ways that it can be determined. Here’s a brief summary of the rules and the complexities.

Under IRC §72(p)(2)(A), a 401(k) plan loan is not treated as a taxable distribution if it does not exceed the lesser of:

- $50,000, reduced by any excess of (1) the highest outstanding balance of loans during the one-year period ending on the date before the date on which the loan was made, over (2) the outstanding balance of loans on the date on which such loan was made; or
- The greater of one-half the present value of the vested accrued benefit, or $10,000.

Got that?

The IRC also provides that if the initial loan taken is less than the maximum permissible $50,000, and the plan allows for multiple loans within a defined period, the participant may request another loan within a year if the aggregate amount does not exceed $50,000; but this $50,000 threshold is reduced by the highest outstanding balance of any loans during the one-year period ending the day before the second loan, in turn reduced by the outstanding balance on the date of the second loan. The rationale for this adjustment in the maximum loan amount is to prevent an employee from effectively maintaining a permanent outstanding $50,000 loan balance.

In addition, the design and administration of a plan loan requires substantially level amortization at least quarterly (e.g., payment through payroll deduction while employed) and that the loan be repayable within five years, or a possible longer period for a loan used to acquire a principal residence.

There can be different ways in which a 401(k) plan administrator determines and computes the highest outstanding loan balance. Here’s the example provided in the recent ISS guidance that explains different ways of determining the maximum amount of a permitted second or third loan.

Assume a 401(k) plan participant (Employee “A”) has a plan balance of more than $100,000 and borrows $30,000 in February. The plan in this example requires that the loan be repaid in monthly increments, but also allows for the loan to be repaid in full at any time. Employee “A” repays the loan in full in April. Then in May, he requests another loan of $20,000, which he repays in full in July. In December, he requests a third loan. Can any loan be granted in this situation since the aggregate amount of all loans taken during the year equaled $50,000? The answer is – perhaps. The plan’s administrative rules could provide that once the aggregate amount of loans reach $50,000, no further loan can be taken in that year. Alternatively, the plan could identify the highest outstanding balance of any loan during that one-year period as being the only amount that cannot be subject to another loan – in the situation described above, that would be $30,000. This would permit a third loan in December of up to $20,000. Thus, the answer to the question of a maximum loan amount when multiple loans are taken can be based on the terms of a plan and its administrative rules.

The IRS indicates to its examiners that if the plan adopts either of these calculations, no further inquiry needs to be made as to the validity of a plan loan. Companies may want to review the terms of their administrative rules with regard to loans and describe the appropriate calculation to plan participants eligible for a loan. Of course, this might also encourage more plan loans if multiple loans are permitted, offset by loan fees.

In the event of a plan loan that exceeds the maximum limit, the recipient employee must make a corrective payment. Otherwise, the excess would be considered a taxable distribution and could also be subject to the 10% penalty tax under IRC §72(t).

Some plans require a participant’s spouse’s written consent before providing a loan greater than $5,000. This is specific to a plan and not a statutory requirement. It also is plan
specific whether an employee must repay any outstanding plan loan following termination of employment. If the loan is not repaid within a defined period – often 60 or 90 days following termination – the employer must treat the unpaid loan amount as a taxable distribution and report it on Form 1099-R. However, the employee could rollover the taxable amount to an IRA within 60 days of the deemed distribution and avoid potential income taxes and 10% early distribution penalty, if he had sufficient cash.

A bill currently being considered by Congress – The Shrinking Emergency Account Losses (SEAL) Act would limit to three the number of loans an employee could take from a qualified defined contribution plan. It would also allow employees to make plan contributions after taking a plan loan, and give employees who leave employment until they file their federal tax return to repay any plan loans.

Another Lawsuit Over Who Is Proper Beneficiary
While it may seem that designating a beneficiary for death benefits payable from employer plans should be fairly simple to explain and administer, there is periodic litigation involving who should receive benefits payable upon the death of an employee. Here’s another recent example.

Iraleth Rizo was a long-time employee of Publix Supermarkets and she participated in the company’s 401(k) plan and employee stock ownership plan (ESOP). The summary plan descriptions (SPDs) of both plans provided specific instructions as to the method of designating and changing a beneficiary. These required the employee to complete a Beneficiary Designation Card which the employee needed to type or print in ink with the name and Social Security Number of the beneficiary. The employee then must sign and date the card. Any beneficiary designation or change would not be valid until the Publix Retirement Department received and processed the card.

In 2008, Ms. Rizo named a niece and nephew to be equal beneficiaries for both the 401(k) plan and the ESOP. However, in September, 2011, she was diagnosed with cancer and ceased working. In January, 2015, after the cancer had progressed and Rizo was getting her affairs in order, she called Publix to find out how to change her beneficiaries. A Publix representative told her that in order to change beneficiaries, she had to complete the Beneficiary Designation Card, but she could also write a letter indicating the new beneficiary, with their Social Security Number and make sure that she date and sign the letter. She had decided to change beneficiaries naming her good friend, Arlene Ruiz, to be the sole beneficiary. Ms. Ruiz wrote the letter and had Ms. Rizo sign and date it. Rizo also completed one of the Beneficiary Designation Cards but instead of dating and signing the card, she simply wrote on it “as stated in the letter”. Both the letter and the card were mailed to Publix. Unfortunately, Rizo died the following day.

The plan administrators determined that since the beneficiary designation card had not been signed and dated, the change in beneficiaries would not be honored. As a result, it paid the death benefit proceeds from both plans to the niece and nephew who had been in the original 2008 designations. Ms. Ruiz filed a claim for the death benefits, which the company denied. She then sued in federal court claiming that the intent of the decedent clearly was to change beneficiaries based on the signed letter and attached Beneficiary Designation Card. A federal district court in Florida recently upheld the actions of the company and plan administrator and denied Ruiz’s claim (Ruiz vs. Publix Supermarkets, Inc.).

The court primarily based its decision on an important 2009 U.S. Supreme Court Case, Kennedy vs. Plan Administrator for DuPont SIP. The Supreme Court concluded that ERISA requires plan administrators to act in accordance with plan documents and instruments governing the plan. This would appear to reject a claim of “substantial compliance”. While several court decisions have applied this doctrine to allow a change in beneficiary even when a plan’s internal procedures are not strictly complied with, the Kennedy case essentially concluded that plan administrators should follow the exact terms of the plan – and in this case, the decedent’s failure to sign and date the Beneficiary Designation Card was deemed insufficient to alter her existing beneficiaries, despite the attached letter indicating that may have been her intent.
Did You Know...

- Ayco’s 2017 Executive Benefit Survey results are expected to be distributed next month to those organizations that participated in this year’s survey.

- Last year, 75% of state and local government workers participated in a defined benefit pension plan, although 57% were frozen plans, according to a U.S. Bureau of Labor Statistics report.

- The Office of Chief Counsel of the IRS issued a letter to a member of Congress indicating that if an individual who is Medicare-eligible funds themselves or receives employer contribution into a health savings account (HSA), the amount should be withdrawn and included in income for that year. However, no “fine” (e.g., penalty) would be assessed by the IRS.

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