INCENTIVE COMPENSATION: HOW TO STRUCTURE AND AVOID LEGAL PITFALLS IN COMPENSATING EMPLOYEES FROM HOURLY TO EXECUTIVE

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I. HOW THE EMPLOYEE COMPENSATION LANDSCAPE IS EVOLVING IN LIGHT OF COVID-19

A. National Compensation Trends

1. The median raise in 2023 is expected to be around 4%, with 25% of employers responding planning to give increases in the range of 5%-6% in 2023.[1]

2. 75% of employees are reportedly willing to leave their job for a salary increase, but state it would take on average a 16.1% increase to leave.[2]

3. Compensation costs for civilian workers increased by 5.1% in 2022.[3]

B. National Compensation Trends – Pay Transparency

1. Currently, eight states have enacted, and 11 are considering pay transparency laws which would require postings for jobs, promotions or transfers to include the compensation or a compensation range for the opportunity advertised.

   a. Michigan has not passed a pay transparency law.

2. The number of U.S. job postings that include salary information more than doubled from 18.4% to 43.7% between February 2020 and February 2023.[4]

3. 63% of employees surveyed by Glassdoor said they preferred to work at a company that discloses pay information over one that does not.[5]

C. National Executive Compensation Trends

1. Using the realized compensation measure, CEO pay has skyrocketed 1,322% since 1978.[6]

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[1] Salary.com, September 2022.

[2] https://www.bamboohr.com/resources/guides/compensation-trends .

[3] US Bureau of Labor Statistics, February 2023.

[4] https://www.hiringlab.org/2023/03/14/us-pay-transparency-march-2023/

[5] https://www.glassdoor.com/research/pay-transparency-survey-2022/

[6] https://www.epi.org/publication/ceo-pay-in-2020/#:~:text=Growth%20of%20CEO%20compensation%20(1978,2020%20(adjusting%20for%20inflation

2. During the pandemic, CEO's realized compensation rose 18.9%.[6]

3. 3.3% of companies reported their "say on pay" shareholder proxy votes failed to gain support, up from 1.9% in 2020 – indicating shareholders are more assertive in regards to executive compensation.[7]

D. Local Executive Compensation Trends

1. According to Zip Recruiter, the average CEO salary in Michigan is $118,290 compared to the national average of $148,441 . CEO salaries in Michigan range from the 25th percentile at $79,035 to the 75th percentile at $173,878.[8]

2. A Michigan Nonprofit Association survey found nonprofit CEO salaries increased almost 30% since their 2010 compensation report.[9]

E. Executive Compensation Landscape

1. **Fair Labor Standards Act:** Executive employees are typically classified as exempt as either an:

a. **Exempt Executive, Professional, or Administrative Employee:** To be exempt, the employee must have certain exempt duties (*e.g.*, professional, executive, administrative, outside sales) and meet the salary basis test, when applicable.

i. **Professional:** Compensation on a salary basis at a rate not less than $684/week; primary duty is performance of work requiring knowledge of advanced type in field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction OR requiring invention, imagination, originality or talent in recognized field.[10]

ii. **Executive:** Compensation on a salary basis at a rate not less than $684/week ($35,568 per year); primary duties include management of the enterprise in which the employee is employed or of a customarily recognized department/subdivision thereof; customarily and regularly directs the work of two or more employees; has authority to hire/fire other employees.[11]

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[7] https://www.shrm.org/resourcesandtools/hr-topics/compensation/pages/executive-pay-growth-during-the-pandemic-faces-scrutiny.aspx

[8] https://www.ziprecruiter.com/Salaries/CEO-Salary--in-Michigan

[9] https://www.freep.com/story/money/business/2019/08/23/nonprofit-ceo-salary/1836964001/

[10] 29 C.F.R. § 541.300

[11] 29 C.F.R. § 541.100

iii. **Administrative**: Compensation on a salary basis at a rate not less than $684/week; primary duty is performance of office or non-manual work directly related to management/general business operations of the employer or employer's customers; primary duty includes exercise of discretion and independent judgement with respect to matters of significance.[12]

iv. **Outside Sales:** Making sales within the meaning of the Act or obtaining orders or contracts for services or for the use of facilities for which a consideration will be paid by the client/customer; and who is customarily and regularly engaged away from the employer's place(s) of business in performing such primary duty.[13] The salary basis test does not need to be met for outside salespersons.

b. **Highly Compensated Employee:** To be exempt as a highly compensated employee, the executive must earn at least $107,432 per year on a salary basis and perform primarily office duties (non-manual work).

2. **National Labor Relations Act:** Non-management level employees have a right to engage in protected concerted activities, which means that they have a right to discuss their wages, along with terms and conditions of their jobs. Because executives are of a management level, and therefore do not have this protected right, employers can generally require executives to keep the terms of their compensation confidential.

3. **The Impact of Diverse and Inclusive Workplaces**: "More than 3 in 4 employees and job seekers (76%) report a diverse workforce is an important factor when evaluating companies and job offers."[14]

a. Broadening job requirements

b. Using inclusive languages in job postings

c. Generational differences in the workplace

i. 94% of entrepreneurs and 88% of job seekers say that a healthy culture at work is vital for success.[15]

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[12] 29 C.F.R. § 541.200

[13] 29 C.F.R. § 541.500

[14] https://www.glassdoor.com/blog/glassdoors-diversity-and-inclusion-workplace-survey/

[15] https://teamstage.io/company-culture-statistics/

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4. To learn what your employees need, consider the data available from onboarding interviews, exit interviews, and other engagement surveys.[16] Remember, the various strata of employees and how needs may differ. For example, in the beginning, mid, or end of an executive's career.

5. Identify the turnover rates and reasons for any attrition. Compare these rates to the Bureau of Labor and Statistics publishes turnover rates by industry.[17]Top 5 reasons employees are leaving jobs:

   a. Higher compensation

   b. Poor interpersonal relationships

   c. Personal life changes (marriage, relocation, growth of family, illness, etc.)

   d. Better benefits package

   e. Promotion and/or increased job responsibilities

II. THE VARIOUS FORMS IN WHICH EXECUTIVES MAY BE COMPENSATED

A. Salary and Severance

1. Guaranteed for a term or at-will?

   a. If term, then define:

      i. Termination "For Cause" can include, for example: breach of fiduciary duties; failure to perform term of agreement; felony conviction; act of dishonesty/loyalty.

      ii. Resignation for "Good Reason" can include, for example: material breach of the agreement by the Company; material reduction in salary/benefits unless due to economic reasons or business necessity; and change location from which executive is working.

      iii. Total Disability – consider whether this will be determined at discretion of employer versus employee's physician.

2. Severance

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[16] https://www.talentlyft.com/en/resources/employee-value-proposition-survey-questions and https://www.talentlyft.com/en/resources/what-is-employee-value-proposition-evp

[17] https://www.bls.gov/news.release/pdf/jolts.pdf

a. Typically, payable upon termination without cause and resignation for good reason.

b. Can include monetary payout as a lump sum, in installments, or as pay continuation. Consider whether it is attributable to a period of time, which would render the executive ineligible for unemployment benefits in any week to which the severance is attributed. If employment agreement is for a term, the severance may allow for a payout of the amounts remaining due for the term committed to between the parties. Severance payments may also include a portion of a bonus to which the executive may otherwise have been entitled. Severance may also include continuation of benefits beyond separation from employment.

B. Bonuses/Incentive Payments

1. What do you want to incentivize?

a. Recognition: "Organizations with formal recognition programs have 31% less voluntary turnover than organizations that don't have any program at all. And they're 12x more likely to have strong business outcomes." [18]

b. "When companies spend 1% or more of payroll on recognition, 85% notice a positive impact on engagement."[19]

c. 40% of Americans say they would put more effort into their work if they were recognized more frequently. [20]

i. More productivity can lead to positive bottom-line improvement.

2. Factors to consider when creating bonus/incentive payment structures:

a. When is bonus considered earned?

i. **Appreciation of value/profit** – earned based on an increase in profit or value of the company. This incentivizes success of company/think like an owner.

ii. **Performance** – earned based on performance attributable to executive. This incentivizes the success the executive and executive's team.

iii. **Time –** earned based on duration of service. This incentivizes retention.

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[18] https://www.quantumworkplace.com/future-of-work/importance-of-employee-recognition

[19] https://www.shrm.org/about-shrm/press-room/press-releases/pages/shrm-globoforce-survey-hr-professionals-indicate-recognition-programs-have-positive-impact-on-retention-and-recruitment-.aspx

[20] https://hbr.org/2016/05/recognizing-employees-is-the-simplest-way-to-improve-morale.html

3. When will the bonus/incentive payment vest?

   a. Consider short-term versus long-term bonus structures, to meet the business goals.

4. How will you calculate the bonus/incentive payment?

   a. **Discretionary** – Retain freedom to decide whether bonus will be paid; no guarantee as to amount or timing.

   b. **Non-discretionary** – when an employer creates an expectation of payment and doesn't control the timing or amount without breaching legal or contractual agreements.

5. Will you disclose the calculation?

   a. Based on EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization)? For example, establish whether there are any adjustments, and if its EBITDA is established by the Board, as certified by independent outside auditors, accountant, etc. Consider whether the executive will be entitled to an accounting of how this amount is calculated.

   b. Profitability versus overhead of individual employee?

6. How is it payable?

   a. **Stock** – delivered as shares of company stock

   b. **Cash** – delivered in cash

   c. **Other benefits** – other fringe benefits or negotiated terms

7. How does incentive compensation affect exempt and non-exempt employees?

   a. **Exempt Employees** – Since exempt employees are not entitled to overtime, an incentive compensation, whether discretionary or non-discretionary, is paid in addition to the guaranteed base salary.

   b. **Non-exempt Employees** – Payment of non-discretionary bonuses (those based on a set of criteria or performance goals) to non-exempt employees increases the regular rate on which overtime is due.

C. Stock Bonuses

1. Consider what kind of stock options you will offer executive, such as:

   a. Restricted stock

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b. Profit sharing ("phantom stock")

c. Purchase plans

d. Stock appreciation "golden handcuffs"

2. Stock options motivate executives to think and act like owners.

3. Think about whether to offer stock options upon hire or over time. Also incorporate in an agreement when such stock vests and how it will be valued. For example, will it be paid out at the amount an employee paid to obtain it, or based on the value of the shares according to an evaluation of the value of the business.

D. Deferred Compensation

1. Severance

2. Purchase of stock

3. Pay continuance of benefits: Consider whether the business will be paying the benefits directly or requiring the employee to submit receipts that will be reimbursed. Also, if a business grants fewer than the full period during with benefits may be extended under COBRA, keep in mind that the executive technically cannot be added onto a spouse's plan after the employer stops making COBRA payments.

4. Profit sharing plan

5. Retirement/savings plans: Although formal retirement plans like a 401(k) has contribution limits, savings plans typically do not have limits unless specified by an employer.

a. Traditional 401(k) – This is the most popular form of retirement.[21] These plans are subject to employee contributions of $20,500 in 2022.

b. Roth 401(k) – These plans are also popular and have contribution limits, as of 2022, of: $6,000 if under 50; $7,000 if 50 or older; and no limit after 70½.[22]

c. Annuity – These are purchased through life insurance company and are typically a sum of money payable to an executive either annually or at other regular intervals, based on an employee's contribution and without limits to such contributions. It can be

[21] https://www.shrm.org/hr-today/trends-and-forecasting/research-and-surveys/pages/2017-employee-benefits.aspx

[22] https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits

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structured as immediate or deferred compensation, with funding from employee that is either before or after taxes. See IRS Publication 575.[23]

d. Defined contribution retirement savings plan (e.g., 403(b), 457 including "Top Hat plans", Thrift Savings Plan). A Top Hat plan typically has the effect of deferring taxation and avoiding certain requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

e. Supplemental Executive Retirement Plan ("SERP") – There is typically no special tax treatment for SERPs, which are considered long-term incentive plans. Payments made under SERPs are considered a business expense when deducted.

f. Pension Plan – These are not common anymore.

E. Expenses and Perks: In addition to health insurance coverage, which may be required under the Affordable Care Act, depending on the employer, here are some perks that competitive businesses are offering employees: relocation expenses/reimbursements; travel stipends; car stipend; phone and plan reimbursement; payments for obtaining and maintaining professional licenses; reimbursement for continuing education expenses; stipend for attending conferences; country club or gym membership reimbursement; luncheon club membership; reserved parking; rent stipend, etc. Keep in mind that some of these may be considered business deductions which may be provided as a benefit not subject to income tax. If not considered a business expense, companies may gross up the amount to cover any taxes that may be incurred as a result.

F. State/City Funded Resources/Benefits

1. State/city relocation programs

a. Alaska pays residents appx $1,000

b. Montana will pay up to $12,500 to new residents plus 35% to offset taxes

c. Vermont will pay up to $7,500 to certain workers

d. West Virginia pays $12,000 to move to certain locations

2. State assists with child care

[23] https://www.irs.gov/publications/p575

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a. Michigan Tri-Share Child Care Pilot Project[24]

i. Pilot model in Michigan where cost of childcare is shared between employer family and state of Michigan

ii. Employer opt in program; employer pays 1/3, family pays 1/3 and state pays 1/3[25]

iii. Reduces cost of child-care; executive must earn less than 300% of Federal Poverty Level; and must be participating employer. The Federal Poverty Level ("FPL"), which is based on family size. For example, FPL is currently $13,590 for household size of 1 (so such executive must earn less than $54,360 to qualify) and $27,750 for household size of 4 (so such executive who is married with two children must earn less than $111,000 to qualify).

G. Fringe Benefits

1. Benefits are a percent of total compensation. Common benefits include:

a. Vacation / sick time / paid time off

i. Mental health days

b. Holidays / bereavement / other

c. Parental Leave

i. Not only provide adequate paid time off, but create a culture that an employee feels comfortable using it. This leave should reflect a home that assumes both parents work full-time and do not receive homemaking support.

d. Medical / dental / vision

i. Medical, dental, and vision

ii. Family planning such as infertility treatments

e. Life insurance – policy owned by company

f. Disability – short term and long term

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[24] https://www.michigan.gov/mwc/initiatives/mi-tri-share-child-care-pilot-project/current-mi-tri-share-child-care-pilot-program-regions

[25] https://www.forwardontalent.org/stories/michigan-tri-share-pilot-program/

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g. Pensions

H. Employee Experiences and Support

1. Home / child care

a. Time and space for women to nurse

b. Time to take off for child-related events/show up (teacher conferences)

2. Housing / rent

3. Educational reimbursements

a. 529 Programs – Michigan Education Trust (MET) and Michigan Savings Program (MESP)

i. Consider matching employee contributions to education.

ii. MESP offers a step-by-step payroll guide and free digital tools to help implement and introduce MESP to employees.

iii. Offers free presentations for organizations to educate staff on ways to save for college and the tax advantages.

iv. Legislation was introduced to Congress that would allow employers to receive a tax credit for small employer costs for establishing direct payroll deductions into qualified tuition programs.

b. "According to a recent Edward Jones survey, about 86% of employees surveyed would participate in a 529 college savings program that was offered as an employee benefit."[26]

4. Payment of student loans

a. Section 2206 of the CARES Act allows for an employer to make up to $5,250 in student loan payments for an employee within a year either directly to the employee or the student loan service.

i. Extended from 2020 through December 2025 as part of the Consolidated Appropriations Act.

[26] https://www.michigan.gov/setwithmet/0,4666,7-374-87547_87680_76301-386906--,00.html

ii. Considered tax free –neither the employee or employer pay income tax on this amount and the employer receives a payroll tax exclusion on that amount.

b. Data from Student Loan Hero shows that 54% of younger employees prefer a student loan payment assistance program over a 401(k) plan.

III. <u>BEST PRACTICES FOR COMPLYING WITH STATUTORY LEGAL OBLIGATIONS</u>

A. Deferred Compensation – 409A Issues

1. When does section 409A apply?

a. When there is a **legally binding right** to compensation that has not been actually or constructively received and that is payable in a later year, except for payments within the short-term deferral period.

i. "Short-term deferral period" ends two and one-half (2 1/2) months following the later of the calendar year or the employer's fiscal year in which the employee's right to receive the payment is no longer subject to **a substantial risk of forfeiture,** with some exceptions.

b. *Some exceptions, including for "grandfathered" deferred amounts and non-collectively bargained involuntary separation pay amounts with some limitations.

2. Why do we care about complying with 409A?

a. Failure to comply results in all compensation being included in income **unless subject to a substantial risk of forfeiture**, with additional taxes including:

i. 20% tax applied to the portions paid in violation of 409A.

ii. 1% penalty on the amounts underpaid as of the date of the deferral or the date when there is no substantial risk of forfeiture, whichever is later.

3. What is required to comply?

a. Plan must be in writing, describe how much will be paid, when it will be paid, and how. Employer must actually pay the promised amount at an appropriate date (409A defines the permissible times), and such payment may not be accelerated or postponed unless it falls under an exception under 409A.

B. Equal Pay /Title VII Obligations

1. Importance of conducting audits of compensation

a. Assess the various strata of employees, by position, years of experience, and other relevant factors to confirm whether pay is equitable for legitimate business reasons.

b. Identify any significant gaps in pay and the respective reason for such discrepancies.

c. Evaluate how and when to resolve pay gaps that do not have a legitimate basis. For example:

i. If discrepancy is based on time of hiring, such as the supply and demand of talent requiring a high rate of pay versus low rate of pay, then there was probably a legitimate reason for the discrepancy but also a need to reconcile the amounts to reinforce morale.

ii. If differences are (whether intentionally or not) resulting in disparities based on a protected class (*e.g.*, age, gender, race, ethnicity, etc.), then evaluate whether there is any implicit bias or structural problem with the onboarding process and reconcile the problem.

d. Consider making adjustments either openly and directly mid-year or through typical annual bonus/pay raise process.

2. Consider opportunities for advancement and who is advancing (or not).

a. Equity versus Equality

C. Restructuring Considerations

1. Conduct adverse impact study when adjustment in staffing, including executives, upon:

a. Change in control

b. Furloughs of employees

c. Re-hiring employees

D. Contractual Obligations

1. Review contract to identify:

a. Remedies upon breach

b. Requirement for arbitration

c. Venue for dispute

d. Governing law

2. If executive is working remotely, consider whether they are considered as doing business in a new state.

a. Flexibility by way of autonomy – According to a study conducted by the Harvard Business Review, 61% of employees reported that they would prefer if management allowed team members to come into the office when they need to and work from home when they need to. [27]

i. According to the same study, 59% of workers say they would not work for an organization that required them to come into a physical office five days per week.

ii. Establish principles over policies; policy-driven mandates on hybrid strategies are likely to be rejected by employees.

iii. Provide employees with the tools, technologies, and training so they may remain effective, autonomous, and connected from anywhere.

iv. 54% of surveyed workers would want to work from home after the pandemic ends.[28]

b. Consider state registration and tax obligations, if you allow executives to work remotely in other states.

i. Where is the employer doing business?

ii. Where is the employer registered to do business?

iii. Where is the employer paying employment taxes?

iv. Business Tax – state and municipal

(A) Some states have *temporarily* waived the business tax nexus for COVID-19 related remote work.

(B) Employment-related taxes

c. "The Convenience Rule": Existed before the pandemic—if an employer is in one state, but the employee lives and works in another state out of convenience rather than

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[27] https://hbr.org/2021/10/forget-flexibility-your-employees-want-autonomy

[28] https://www.pewresearch.org/social-trends/2020/12/09/how-the-coronavirus-outbreak-has-and-hasnt-changed-the-way-americans-work/

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because the employer requires it, then the employee owes income tax to the state where the job is based as well as the state they are domiciled.

d. Conflicts in taxation responsibilities

i. Over the past year, in particular, there have been cases where taxes are being claimed both by the state where the employer does business and the state where remote employee is working

ii. These conflicts between state laws and imposition of out-of-state laws on the worker and the business directly affects employers who permit employees to work out of state during COVID-19.

iii. Employers should consider applicable state laws and case law to determine whether and which taxes may be owed in the state where the remote employee is working.