



How Tax Influences HR Decisions — And Why You Have a Vested Interest

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Agenda

- Introduction
- Elements of a compensation and benefits program
 - Retirement plans
 - Stock options
 - Deferred compensation
 - Cafeteria plan
 - Health benefits
- Program design
- Q&A

Introduction

- Human Resources must use a combination of programs to attract, motivate and retain employees:
 - Salary
 - Bonus
 - Short and long term disability
 - Stock options*
 - Deferred compensation*
 - Retirement plans*
 - Cafeteria plan*
 - Medical (CDHP)*
 - Vision
 - Vacation/sick days
- Human Resources must coordinate with the tax department to ensure the company's financial needs, in addition to the employee's, are being satisfied
- Understanding these programs may affect where you look for a job and can assist you in asking the right questions when you receive an offer!

*Programs covered in today's presentation

Retirement plans - Overview

- There are two types of retirement plans - defined contribution plans and defined benefit plans
- Defined contribution plans
 - The benefit is determined by the amount the employee contributes, the amount of employer contributions, and the performance of the market
 - Example: 401(k) plan
- Defined benefit plans
 - The benefit is determined by a formula, which is typically based on earnings history and years of service
 - Example: Traditional pension plan

Retirement plans - 401(k)

- No guaranteed benefit level at retirement
- Employee makes deferrals out of other compensation (salary or bonus)
- Employer may also make contributions, often as a match
- Employer's liability ends after the money is contributed into the fund
- Typical arrangement may be:
 - Employee contributes 5% of salary;
 - Employer matches 100% up to 3%; and
 - Employer makes profit sharing contributions depending on the company's performance during the year

Retirement plans - Traditional pension plan

- Guaranteed benefit level at retirement
- Employer absorbs all the risk
- Contributions come from the employer only
- Employer's liability ends after the money is distributed to the employee
- Typical benefit would be:
 - Annual payments of \$40,000 commencing at retirement and continuing until death

Retirement plans - Requirements

- Nondiscrimination and penalties for noncompliance
 - Retirement plans are not permitted to discriminate against non-highly compensated employees in favor of highly compensated employees
 - Failure to follow the retirement plan rules could result in the plan being disqualified for tax purposes
 - Loss of deduction for employer contributions that were not vested when made
 - Vested employer contributions to the plan are included in income
 - Trust loses tax exempt status and pays tax on its income

Poll question

Which is not a feature of a defined contribution plan?

- Employee makes contributions to the plan
- Employer makes contributions to the plan
- The benefit is calculated based on a formula, typically including years of service and average compensation
- The risk is absorbed by the employee

Stock options - Overview

- What is an option?
 - Contract to sell property
 - At a stipulated price
 - For a finite period
 - Buyer is not obligated to buy
- Advantages
 - Rewards employees for the creation of shareholder value
 - Only provides value to an employee if stock price appreciates
 - Employee controls date of taxation
- Nonqualified vs. incentive stock option (“ISO”)

Nonqualified stock option (“NSO”)

- Income equal to the “spread” (the difference between the exercise price and the FMV) is recognized on the exercise date
- The employer is equal to a deduction in the same amount
 - For example, an option with an exercise price of \$5 is exercised when the stock is trading at \$20. The employee has \$15 of compensation income and the company gets a deduction for \$15.
- Capital gains recognized when the stock is sold
 - Stock is sold three years later when trading price is \$30, \$10 is taxed at the capital gains rate (15% in 2008)

Incentive stock option (ISO)

- No taxable event to the employee until they sell the stock, if share is held until the later of:
 - 2 years from the date of grant or;
 - 1 year from exercise
- No deduction for the employer
- Example: An option with an exercise price of \$5 is exercised when the stock is trading at \$20. No income is recognized by the employee and there is no deduction for the employer.
- Capital gains recognized when the stock is sold
 - Stock is sold three years later when trading price is \$30, \$25 is taxed at the capital gains rate (15% in 2008)
- If the holding period is not met, the ISO converts to a nonqualified stock option

Poll question

An nonqualified stock option with an exercise price of \$10 is exercised 3 years after grant when the fair market value of the stock is \$30. What amount is included as income for the employee and deductible by the employer upon exercise?

- \$0
- \$20
- \$30
- Not enough information to determine

Deferred compensation

- “Deferred compensation” is a general term used to describe compensation earned in one year but taxed in another
- Employees are subject to income tax upon distribution but may be subject to Social Security and Medicare taxes earlier
- A common example: A bonus plan with payment on the earlier of separation from service or death

Cafeteria plan

- Special plan which allows employees to choose between certain benefits and cash
- Plan can provide for a number of pre-tax choices: medical, accident, disability, vision, dental, group term life, child care expenses
- Cafeteria plans must be in writing and must not discriminate in favor of highly compensation employees
- Assume an employee in the 28% tax bracket typically pays \$1,000 a month in child care. By paying through a cafeteria plan, the employee saves \$280 in federal taxes.

Health benefits

- Many companies offer health coverage. The employer may also cover a portion of the costs.
- More companies are shifting away from traditional health plans and to consumer driven health plans (“CDHPs”) due to rapidly rising medical costs
- CDHPs generally means:
 - Employer pays a fixed amount toward employee's health benefits;
 - Employee has an untaxed account to pay health care bills;
 - Unspent money in the account accumulates for future years;
 - The account is accompanied by high-deductible health insurance that pays for major expenses; and
 - The employee gets on-line support to track health care bills, maintain health, get information on provider quality, and get discounted prices.

Poll question

TRIVIA QUESTION: According to a 2007 survey, what percentage of private sector workers have access to an employee stock option plan?

- 15%
- 30%
- 8%
- 2%

What will my job offer look like?

- Salary
- Benefits
- Maybe:
 - Bonus
 - Stock options
 - Deferred compensation

How does an employer decide who gets what?

- Salary and benefits are commonplace for most positions
 - Unless the job is a sales position and commission only
- After that, it gets interesting...

How does an employer decide who gets what? (cont.)

- Participation in a bonus, deferred compensation, or stock option plan is generally based on:
 - Position or title,
 - Salary level or grade,
 - Some combination of the two

Can companies do whatever they want?

- Sort of, but...
 - The tax advantages (or disadvantages) have driven competitive practice
 - Companies compete for the best talent, and as a result, there are certain table stakes to recruit talent

So, why doesn't everyone get the same pay?

- Skills and talents carry different values in the market place
 - Not any different than professional sports
- Pay differences occur almost from the start, and...
- Get more pronounced as you move up in the organization

What do the top executives get?

- Generally, the top executives participate in:
 - Bonus plans,
 - Stock option plans, and
 - Deferred compensation
- The plans are usually the same, but the levels are a different story...

Is that fair?

- The spread between the lowest paid employee and the highest paid has grown dramatically over the last 30 years
- A debate for society, and in tax policy—is the wage gap something that should be, or can be, addressed through the Internal Revenue Code?

Ok, how do I get that deal?

- Practice, practice, practice...
- Pay is related to performance. But, your range of choices is limited to the employer's menu of plans.
- And, that is driven by the tax consequences to the company

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