WEIGHING DIRECTOR PAY DEFERRAL PROGRAMS

A look at the pros and cons of adding deferral choices to director compensation programs.

DIRECTOR PAY PRACTICES RARELY receive the same level of attention as CEO and executive pay programs. Yet, at a time when board members are being asked to put in more time and take on more responsibilities, regular reviews of the structure, design and level of director compensation are more critical than ever.

The need to attract and retain high quality board talent in recent years has led to compensation program changes, including greater emphasis on equity grants as a way of aligning director pay with the interests of the shareholders they represent. The result has been an uptick in both the overall amount of director pay and interest in offering directors opportunities to defer cash and equity compensation to avoid immediate taxation.

Generally, today's directors receive a mix of cash and equity for their service, with the latter typically awarded in the form of restricted stock units that vest a year from the date of the grant, says Ted Simmons, a principal with FW Cook. "Cash is taxable in the year it's paid, and the equity grants are taxable when they vest—so you essentially have directors who may face a pretty sizable tax bill on their equity awards each year," he explains. "And while companies can withhold shares to satisfy tax obligations for employees receiving equity grants, they can't do that for non-employees like directors."

Directors receiving RSUs, therefore, often face two less-than-palatable options: Sell shares to pay the tax—potentially signaling a lack of confidence in the company in the process—or pay the tax liability out of pocket. Adopting an equity deferral program, however, lets boards avoid creating taxable events for their board members by allowing them to defer compensation—and a director's related income and self-employment tax obligation—until a later date.

Director Equity Deferral Program Pros and Cons

NON-EMPLOYEE DIRECTORS	
ADVANTAGES OF PLAN PARTICIPATION	**DISADVANTAGES OF PLAN PARTICIPATION**
• Tax advantaged savings opportunity (no income or SECA taxes until distribution) • Assuming no increase in tax rates and a rising stock price, deferral results in greater net-after-tax value realization (larger investment grows before tax event) • Deferred stock units can count towards director stock ownership requirement; pre-tax accumulation enables faster goal attainment and stronger stockholder alignment • Deferral mitigates pressure on directors to sell shares to cover taxes while actively serving on a board or, conversely, the need to make out-of-pocket cash payments to cover taxes due upon vesting	• Section 409A rules are onerous and inflexible, with reduced liquidity and significant delays around changing deferral elections and distribution timing • Plan security: no protection in the event of insolvency—the participant is a general, unsecured creditor of the company
COMPANY	
ADVANTAGES OF PLAN SPONSORSHIP	**DISADVANTAGES OF PLAN SPONSORSHIP**
• Potentially makes program more attractive to participants • General stockholder acceptance and not subject to external criticism	• Company's ability to take tax deduction on deferred amounts is delayed • Administration costs and regulatory requirements

DEFERRAL DECISIONS

Known as non-qualified deferred compensation plans, deferral programs can be mandatory or voluntary. In a mandatory deferral program, the company pushes off distribution of the equity, typically until a director leaves the board. While this guards against directors signaling a lack of confidence in the company by selling shares, it can present other issues, notes Austin Lee, a principal at FW Cook. "Companies want to avoid a situation where a director leaves the board just so they can liquidate shares. This can be handled through elective deferrals."

With elected deferral plans, directors are able to choose to defer all or part of their equity compensation to a later date. "It's a way to provide tax-planning flexibility for directors," explains Lee. "By allowing directors to postpone their tax obligations, elective deferral plans mitigate pressure on directors to sell shares to cover the taxes while they serve on the board. It also spares them from having to make out-of-pocket cash payments to cover taxes due upon vesting."

Directors interested in further lowering their taxable income may also look to defer their cash compensation, he adds. "Some directors ask to receive their cash compensation in the form of equity in order to build a larger position in the companies on whose boards they serve and to avoid current taxation on that cash compensation. Others ask to defer tax obligations without increasing their stake in the company by having cash compensation put into an interest-earning savings account or into funds similar to those available to employees under the 401(k) plan that are deferred." All of these elected deferral options share the same overall purpose: deferring tax and self-employment tax liability to a later date.

CAVEATS FOR COMPANIES AND DIRECTORS

While deferral programs benefit companies by mitigating pressure on directors to sell shares in order to cover taxes while serving on their board, they come with drawbacks. For example, companies lose the ability to take an immediate tax deduction on deferred amounts. Instead, the company accrues a deferred tax asset until the distribution is made.

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> **—Austin Lee, FW Cook**

Administrative costs and regulatory requirements can also be prohibitive, particularly for smaller companies. "There's a very real cost in terms of time and administrative burden, related to implementing and managing these programs," says Simmons, who adds that the burden can vary by company. "The degree depends on what's already in place in terms of equity plan administration software, as well as the level of flexibility companies want to provide to directors. The more choices you give, the more things the company will need to track internally."

Conversely, limiting choices can reduce costs. For example, while it is possible to allow participants to defer up to 100 percent of the equity grant in 1 percent or another defined increment, companies looking to minimize administrative costs may want to consider allowing only a 100 percent or all-or-nothing deferral. Companies may also simplify administration by setting deferred pay at termination of service for any reason rather than allowing participants to specify a deferral period each year.

Directors should also be aware of the risk of participating in a deferred compensation program at a company with an uncertain future. Because deferred compensation is unfunded until distribution, directors owed deferred compensation will be treated as unsecured general creditors to the company in the event of insolvency.

Boards contemplating deferred equity awards should also be mindful of Section 409A compliance requirements and review the definition of shares owned in their ownership guidelines to make sure that it encompasses deferred stock units. "You wouldn't want directors to sacrifice progress toward their guideline requirement just by virtue of choosing to defer when they're actually building up a large balance of equity," says Simmons. "So it's good housekeeping to look at your ownership guidelines and make sure that you include shares held in deferral plans and to partner with strong tax counsel to ensure compliance with all applicable codes and regulations." However, unless company guidelines define director stock ownership as real shares owned, deferred stock units will count toward director stock ownership requirements and can actually enable faster goal attainment by mitigating pressure to sell shares to cover taxes.

Finally, elections must be made prior to the beginning of each calendar year in which RSUs are granted, which means companies considering amending director compensation plans to allow for elected deferred compensation in 2024 should move swiftly. "Setup and implementation tends to take a few months, so this would be the time to start exploring a change," says Simmons. "Companies looking to offer deferral opportunities for 2024 compensation will need to have their directors fill out an election form before the end of the year."

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