How to do long-term

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Long term cash and stock based compensation has become standard fare for most private sector companies in their drive to attract, retain and motive top executives. As a result many senior executives in Sri Lanka today participate in various forms of long term incentive programs that are normally based upon individual and company performance. These long-term incentive plans, particu-larly equity participation, have always been an important component of executive reward and compensation. The stagnant economy, shortage of executive talent, and MNC influence in the market over the last few years has created interest in long-term incentives; most private companies are now using long-term cash and stock based rewards to compensate their executives. Most companies in Sri Lanka who have introduced such schemes company wide without a detailed review of a company's executives reward system with tax, legal, and human resource are finding it difficult to sustain the incentive program in the medium and long term. Any reward package selected must be designed to motivate its key executives to accomplish the company's key success factors, while at the same time fulfilling the executive's extrinsic and intrinsic needs of rewards and recognition. There are generally three objectives accomplished with a well-designed long-term compensation plan. The first objective is the attraction, motivation and retention of skilled senior executives. The second objectives is the alignment of the personal interests of those executives with the interests of the shareholder, thereby forging a strong link between performance and compensation and providing an incentive to increase share holder value. Finally, the plan should be tax-effective; that is, it should defer and possibly even reduce the incidence of taxation on executive compensation.

Tax Effectiveness

Tax effectiveness is critical to the design and operation of long-term compensation plans, failing which the actual and perceived value of the plan to participants will get significantly reduced. There are many innovative variations in long-tern compensation; however, the most commonly employed plans are briefly described below. These alternatives are not mutually exclusive and could be used in combination as a "mezzanine" plan.

Although a detailed discussion is beyond the scope of this article, among the most important tax issues to be resolved are the provisions of the income tax act that deals with the salary deferral arra'ngements and the availability of a deduction to the employer. Naturally, the relevance of these issues in any situation will depend upon the nature and design of the plan.

Salary Deferral Arrangements

The first category of long-term incentive plans involves agreements pursuant to which the employer undertakes to make a future payment in respect of current services, with the objective of deferring the related tax liability. The amount payable typically bears some relation to an increase in share value and the payment may take the form of cash or shares. The amount paid must depend upon the average market value of shares of the capital stock of the employer company. In addition, the arrangement may not contain any provision intended to provide shelter from a decline in the fair market value of the employer's shares. These plans are often described as full value phantom stock plans and taxed as income from office or employment rather than as a capital gain. In some countries the employer will be entitled to a deduction in respect of amounts paid.

Phantom Stock Plan

A phantom stock plan is essentially a special type of deferred bonus arrangement, usually based on the fair market value of the shares of the employer company. Such plans do not involve the actual issuance of shares of ownership of equity by employees. Rather, phantom plans involve the creation of units that shadow the current fair market value of the employer company shares. In situations where private companies are involved, units will appreciate or depreciate based on defined factors, such as, for example, the increase in return on investment, the achievement of profits on a consistent basis in excess of budgets, including corporate, divisional and personal performance. The units typically have no value at the time of award but may subsequently acquire value. Such plans provide for vesting after a given period of time and typically provide for forfeiture in the event of dismissal. At the time of vesting, a calculation is made of the value of the accumulated units and such amounts are then paid to the employee as a bonus. It is also typical for additional units to be created when dividends are paid on the shares of the company. It should be noted that the payment to the employee is taxed as cash compensation, and does not involve any special tax considerations. No actual share issuance occurs; therefore any amount to the employee will be taxed.

Stock Options

Another category and perhaps the most common form of long-term incentive plan is the stock option. The traditional stock option plan involves extending to the employee a right to acquire shares of the employer for an exercise price that is projected to be less than the fair market value of those shares at the time of acquisition. Typically such rights do not vest until a specific period of time after their grant. No deduction is generally available to the employer company in respect of the provision of stock option benefits. From the employee's perspective, there are generally no immediate tax consequences on the grant of an employee stock option.

Share Appreciation Rights (SAR)

As an alternative to stock options some MNCs develop an employee remuneration plan which is based on the performance of the company's stock while retaining deductibility to the employer. This stock right is essentially a hybrid between a traditional stock plan and a phantom stock plan and combines the tax benefits of both types of plans. The basic SAR enables the employee to choose to exercise either the SAR or the option. If the employee elects to exercise the SAR or the option a cash payment will be made equal to the difference between the fair market value of the optioned stock and the option price. The employee will concurrently surrender the rights under the option.

Conclusion

The list of plans described above is by no means exhaustive. With the myriad of options available, the development of an appropriate long-term incentive plan for a particular company is challenging and the effectiveness of the plan will depend on the capability of the firm's Human Resources and Finance Department. An innovative approach to plan design and delivery could involve the use of a 'cafeteria plan' similar to the approach commonly used to deliver employee benefits. This strategy enables the executive to tailor his or her long-term compensation to suit individual circumstances. Consequently, greater value is delivered and the three objectives described before are most likely to be met. Today, long-term compensation plans are critical to structuring competitive remuneration packages for the executives of private sector companies. The cafeteria approach to delivery represents an innovative new application of existing principles.