The Forgotten Participant:

Nonqualified ESPPs for Your Essential Workers

Elizabeth Stoudt and Robyn Shutak

April 2020

INFINITE EQUITY

Computershare

Background and Current Market Environment

The COVID-19 pandemic has placed compensation and benefits front and center, particularly for front-line employees ("essential workers") like grocery store, warehouse, and food-service workers who do not have the luxury to work from home. These employees do not necessarily have adequate safety gear, access to health care or paid family and medical leave[1], decent pay, or a strong voice in the workplace to ensure fair treatment. Yet, they are making it possible for countries to continue to operate during the crisis at the risk of getting sick[2].

On the brighter side, some companies have generously stepped up to support their essential workers, offering incentives to reward them for doing their jobs during this extremely difficult time, ranging from wage increases, additional paid time off, cash bonuses or financial assistance (e.g., Wells Fargo, Kroger Co., and Starbucks). These 'special' temporary incentives are well deserved by the hard-working rank and file employees and may provide a short-term motivation and retention benefit in a tough market. However, this is not a widespread practice, and most companies are looking for ways to reduce cash spending. We believe companies should really be thinking longer-term on how to sustain engagement, motivation, and retention for this critical part of their workforce.

The Case for Offering Equity to the Forgotten Workforce

As total rewards professionals are being called upon to recommend innovative compensation and benefit strategies and/or new policies and programs designed to retain and motivate their essential workers, companies should consider equity compensation in their strategy. An engagement proposition that includes an ownership stake in the company is one of the very best ways to make people feel good and valued in recognition for their services and provides benefits that will last long after this crisis has passed—something that cannot realistically be achieved through a one-time cash bonus. Companies that can maintain employee engagement during times of uncertainty are much more likely to flourish, in part because engaged employees are more likely to come up with innovative ideas for saving money and generating new products.[3] Altogether, how each of your employees think and feel is a better representation of your company than all your marketing and advertising material ever could be.

The case for ownership becomes even more compelling and equitable for companies who are suddenly facing cash constraints with no other means to recognize their essential workers. Companies may not be able to increase salaries or hourly wages, nor offer compelling pay packages based on cash alone when recruiting new employees. Additionally, losing employees can have heavy repercussions in terms retraining time, cost, and lost skills. Granting equity in lieu of cash-based

[1] Only 48% of leisure and hospitality workers have access to paid sick days, according to the U.S Bureau of Labor Statistics, National Compensation Survey 2019. Only 9% of these workers have the ability to work from home.
[2] As of April 13, 2020, the United Food and Commercial Workers International Union (UFCW), which represents over 900,000 grocery workers, estimated that 30 UFCW members have died from COVID-19 and nearly 3,000 UFCW members have called out sick after showing signs of illness.
[3] Gallup reports in the 2013 "State of the American Workplace" that companies with a critical mass of engaged workers have higher earnings per share and recovered from the 2009 recession at a faster rate.

incentives can help preserve cash and enable companies to put their money toward operating expenses while ensuring critical staff is fully recognized and not at risk of leaving later. Further, giving employees the ability now to participate in the growth of the company will undoubtedly incentivize them to show up to their jobs, work harder and smarter, and make them less likely to leave in the future.

What if you could offer a benefit that not only supported your talent acquisition and retention strategy, but improved your essential workers' overall compensation? An employee stock purchase plan ("ESPP") is an employer–sponsored savings vehicle that allows workers to purchase company stock with after–tax income, typically at a discount. ESPPs encourage workers to save money, are never underwater at purchase, generate cash flow and tax deductions for the company, and are generally protected from macroeconomic disruptions. There are two broad types of ESPPs:

- **Qualified plans**: Designed in compliance with IRC Section 423 and give tax-advantaged treatment to participants if they meet certain holding requirements. Regulations include benefits offered, length of offering period, eligibility requirements, and many other facets.
- **Nonqualified Plans:** Not designed in accordance with any IRC section and may be structured in many ways.

Why Nonqualified ESPP with a Match?

A nonqualified ESPP with a contribution or share match is a compelling alternative to a traditional qualified ESPP with a discount, particularly if a company wants to structure a program to target its essential workers who tend to be hourly workers or have a lower wage base.

- **Easy to Understand and Communicate:** A match is a simple concept to understand, as employees already have familiarity with the concept from 401(k) plans.
- **Greater and More Flexible Offering:** A nonqualified ESPP can offer matches greater than qualified plan benefits, which are limited to a 15% discount and a lookback feature.
- **Differentiated Matches:** A nonqualified ESPP could offer a tiered match such that the greatest match is at the lowest tier of contributions, targeting lower paid employees who may not be able to contribute at higher levels.
- **Simpler Tax Treatment:** While a qualified ESPP can potentially offer preferential tax treatment to US-based employees, it is much more complex compared to a nonqualified plan where the tax on the match is simply due at purchase.
- **Globally Unified Tax Treatment:** All employees are treated equally and are taxed at purchase regardless of location. When companies offer locally tax qualified programs, local employees receive a tax benefit that employees nowhere else in the world receive, which creates an inherently unequal benefit.
- **Simpler Compliance:** No disposition tracking is needed and there are no Section 6039 reporting requirements. Additionally, it is simpler to exclude certain countries from participation.

Design Features and Alternatives

An initial step in designing an ESPP is to identify the goals of the plan. For this article, the context is designing a plan that targets essential workers, many of whom have a lower wage base, and providing a meaningful enough benefit such that they are financially capable of participating. Here are key decisions companies must consider when designing an ESPP:

Design Feature	Considerations
Match	• Can be set at any level and can vary at different contribution levels (for example, could be structured so that highest match is at lowest tier of contributions to ensure plan is reaching lower paid employees) • Plan should have flexibility to adjust the match over time, so plan can adapt to changing company needs (for example, increase the match as financial situation improves)
Purchase Period	• Tend to be shorter in length (i.e., monthly) • For lower paid workers, frequent purchases provide liquidity • Companies with high stock prices (greater than $100) may consider longer periods as employees contributing at lower levels require more time to build up contributions to purchase a single share
Fractional Shares	• Allows all employees, particularly those participating at lower levels, to immediately purchase shares and benefit in the company's growth • For companies with high stock prices, no fractional shares could be a deterrent to low wage employees who wait longer to purchase a single share and have liquidity in their savings
Contribution or Share Limits	• Typically, plans include annual contribution or share limits • While not constrained under the qualified limits, nonqualified plans still share a similar goal of providing a broad-based, non-excessive benefit which is shareholder friendly
Cashless Participation™	• Allows employees to contribute a minimum amount and supplement contributions with an interest-free loan which is repaid at purchase • Employees purchase more shares • Provides greater cash inflow to the company • With a nonqualified plan, this feature could be offered only to certain employee groups, such as hourly employees or employees making less than a certain amount
Vesting	• Can attach vesting requirements to matched shares • Typically, they are relatively short-term, e.g., six months or one year • Defers taxation on matched shares until vest • May better support company's retention objectives
Holding Periods	• Can attach mandatory holding requirements on all shares purchased • Typically, holding periods are six months or one year • Encourages employees to act more like long-term shareholders
Employee Eligibility	• Easy for companies to exclude certain groups of employees from participating, such as employees in certain countries, or part-time or seasonal employees

The flexibility of a nonqualified plan means that it can be structured in a way to meet a company's goals and balance financial or share constraints. Here are two examples of certain types of companies who have been significantly impacted by the COVID-19 pandemic, but in vastly different ways. Most companies will fall somewhere in between, so this illustrates a range of design considerations.

Companies with strong revenue and cash flow and increases in staff	Companies with revenue declines, closed operations, layoffs, and/or furloughs
• Examples: big box stores, grocers, food supply chain, consumer staples • Offer significant matching programs • Offer a stipend (i.e., $20 per month), potentially only to hourly workers, certain pay grades, or employees with salary below a certain level • Frequent purchases (i.e., monthly) • Cashless participation to support employees with little to no disposable income • Strategy: Immediate as employee engagement and retention are crucial during the pandemic with workers risking their health as they keep working	• Examples: restaurants, non-essential retail stores, airlines, oil and gas • Offer a modest matching program; companies with strong dividends (like oil companies) can promote benefit of a smaller match plus value of dividend • One-time stipend to kick-start program to encourage participation for previously furloughed or laid off employees without an ongoing company cash outlay • Frequent purchases (i.e., monthly) • Cashless participation to support employees with little to no disposable income • Strategy: Mid-term as stores begin to re-open, revenue gradually increases, and company needs to both retain and attract workers; cannot assume furloughed employees will automatically come back as numerous companies begin to hire

Financial Impact to the Company

Companies have varying degrees of restraints around cash flow, non-cash compensation expense, and share usage. It is important to understand the full impact of an ESPP to the company.

- **Dilution:** An ESPP is less dilutive than a broad-based RSU or stock option program, making these plans attractive to shareholders. Generally, these plans have limits on contribution levels, so they are non-excessive like their qualified counterparts. The ultimate dilutive impact depends upon the source of shares. Open market purchases are not dilutive to the company while treasury shares are dilutive. Many plans utilize more than one source of shares over the life of a plan and can be flexible to changing company needs.
- **Compensation Cost:** A non-cash charge to the company. With a match, the expense is equal to the value of the match and depends upon actual participation and contribution levels.
- **Taxation:** It is taxed the same as a nonqualified stock option. This is a significant benefit as there is a tax deduction at purchase, compared to qualified plans where there is only a tax deduction

upon a disqualifying disposition. Tax withholding can be managed much like it is for stock option exercises, such as through payroll or share withholding.

- **Compliance:** There is no disposition tracking or Section 6039 reporting, making compliance much easier.
- **Cash:** Employee contributions represent cash inflow, so increases in participation and contribution levels represent additional cash inflow. On the other hand, open market purchases require cash outlay to purchase shares. Cash is also required for companies who offer a stipend.
- **Administrative Cost:** The administrative cost is similar to a qualified plan and largely driven by the value of the purchases and the number of purchases each year.

Key Takeaways

This crisis has cast the essential workers of the world in a new light. Merely paying an hourly wage (and maybe a one-time recognition bonus) to essential employees who face serious health risks will not sustain engagement and is short sighted given their vast contributions to companies and their retention risk. As such, companies will likely face growing pressure to provide enhanced incentives that provide a retentive effect to their essential workers and should take proactive measures now to enhance their programs.

ESPP programs cultivate ownership and should be an integral part to advancing long-term talent attraction, engagement, and retention strategies for essential workers. Employee ownership becomes even more compelling and equitable for companies who are suddenly facing cash constraints with no other means to recognize their essential workers. A nonqualified ESPP can offer a range of design features for companies in different financial situations.

If attracting and retaining essential employees is top of mind and you have had little incentive in the past to review your benefit programs for long-term competitiveness for your hourly employees, now is the time to act.

Author Information

Please don't hesitate to reach out to the authors below with questions.

Elizabeth Stoudt, ASA, CEP
Infinite Equity, Partner
liz@infiniteequity.com
+1.908.380.0144

Robyn Shutak, CEP
Computershare, Equity Advisory Services Practice Leader
robyn.shutak@computershare.com
+1.310.343.5221