Cash Awards Offered as Part of a Global Long-Term Incentive Program: Legal and Tax Considerations

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This practice note discusses legal and tax considerations companies offering equity awards on a global basis may encounter when trying to provide similar benefits to eligible employees across a large number of non-U.S. jurisdictions. There may be prohibitions against equity awards, expensive filings where headcounts do not merit the expense, negative tax impacts for the company or the employees and/or complex administration that the company cannot support. In such cases, companies often wonder whether these challenges could be avoided by granting cash awards instead. The answer to this question is not straightforward—it may depend on which particular issues are under consideration and the company's priorities and grant strategy.

In some cases, cash awards may avoid some of the complicated issues that are associated with equity awards. In other cases, cash awards may not avoid such issues, or they may avoid such issues but create different issues.

This practice note summarizes the key considerations for granting cash awards, explains how such awards may or may not address the challenges associated with equity awards, and provides guidance for companies that decide to grant cash awards to a global population.

The practice note addresses the following key topics:

- Forms of Cash Awards
- Benefits of Cash Awards
- Downsides of Cash Awards / Benefits of Equity Awards
- Implementation of Cash Awards
- Conclusion

For a discussion providing legal guidance for practitioners whose U.S. corporate clients are developing equity-based compensation plans for granting equity awards to employees both within and outside the United States, see Global Equity Plan Design and Implementation. For additional equity compensation resources, see the Equity Incentive Plan Resource Kit. For the application of Section 409A of the Internal Revenue Code to equity compensation arrangements, see Equity Award Drafting Checklist (Section 409A Compliance).

Forms of Cash Awards

In the compensation context, cash is used for a variety of purposes. First and foremost, cash is (and, in most jurisdictions, must be) used for salary payments. In addition, cash is frequently used for annual bonuses and short-term incentive programs. The main focus of this practice note is on cash awards that are used as part of a company's long-term incentive program and, in particular, on awards that are intended to replicate—to the extent possible—the company's equity awards when the company cannot or does not, for some reason, want to grant share-settled equity awards.

Cash-Settled Equity Awards

A cash-settled equity award (also referred to as a phantom award) is an award that derives the amount of cash to be paid from the value of the company's shares. The most common types of these awards are cash-settled restricted stock units (RSUs) and cash-settled stock appreciation rights (SARs).

Cash-Settled RSUs

A cash-settled RSU constitutes an unsecured, unfunded promise by the company to make a cash payment to the grantee in an amount that is equal to the fair market value of the company's shares on the date the applicable vesting conditions are met. The vesting conditions may be based on the completion of a certain period of service within the company group and/or the achievement of prescribed performance goals.

Typically, the cash payment is automatically made to the grantee when and to the extent the vesting conditions are met. Some companies couple these awards with a deferral feature allowing the grantee to defer receipt of the cash payment until a later date. Like share-settled awards with a deferral feature, special attention must be paid to the structure of the deferral to avoid adverse tax consequences in certain countries. Many companies that offer cash awards with a deferral feature limit the availability of the deferral feature to executives and directors.

Cash-Settled SARs

A cash-settled SAR constitutes an unsecured, unfunded promise by the company to make a cash payment to the grantee in an amount that is equal to the appreciation in the fair market value of the company's shares between the date of grant and the date of exercise, provided and to the extent the applicable vesting and exercisability conditions are met. Similar to a cash-settled RSU, the vesting conditions may be based on the completion of a certain period of service and/or the achievement of prescribed performance goals. Unlike a cash-settled RSU, the grantee typically must take action to exercise the cash-settled SAR in order to receive the cash payment although some companies structure the SAR to be automatically exercised as soon as the vesting conditions are met.

Companies may grant cash-settled awards that include the discretion for the company to settle the award in shares instead (or, vice versa, the company may grant share-settled awards that include the discretion for the company to settle the award in cash). In some cases, certain regulatory or tax issues associated with share-settled equity awards may be avoided provided the award is ultimately settled in cash, even if the award included some discretion to be settled in shares. In other cases, there must be no discretion to settle in shares to avoid the applicable requirement.

For U.S. tax treatment of a SAR award and exercise, see Executive Stock Options and Stock Appreciation Rights § 3.04, "Tax Treatment of Stock Appreciation Rights."

Other Cash Awards

There are other kinds of cash awards that companies may consider when seeking to address certain regulatory and tax issues associated with share-settled equity awards.

Cash Bonuses (Payment Amount Set at Time of Grant)

A cash bonus where the amount of the cash payment is set at the time of grant, but the payment is subject to satisfying the applicable vesting conditions. In this case, the amount may depend on the company's share price at the time of grant or some other metric, but it does not change throughout the vesting period (although some companies may provide for interest to accrue over the vesting period).

This award does not fully replicate an equity award since the ultimate payment does not reflect changes in the share price over the vesting period. However, it has retentive value since the grantee will only receive the payment if they provide the requisite services or otherwise satisfies the relevant vesting requirements.

Cash Bonuses (Performance-Based)

A cash bonus where the amount of the cash payment depends on the achievement of certain performance metrics that are not directly or solely tied to the company's share price (e.g., revenue, profits).

Again, this award does not replicate an equity award since the payment is not dependent upon the company's share price and is often used to motivate more specific performance efforts such as performance within a certain business division or a certain geographic region.

The distinguishing factor for these types of cash awards (versus cash-settled equity awards) is that the payment is not dependent on the development of the company's share price. This can be a decisive factor in analyzing the regulatory compliance issues for awards in certain countries.

Cash-Settled Profits Interest Units

A profits interest is an equity vehicle widely used by U.S. partnerships (or U.S. limited liability companies taxed as partnerships). It represents an ownership interest in the growth rather than in the current value of the partnership and, in the U.S., any appreciation is taxed as long-term capital gains rather than as ordinary income. Outside the U.S., the tax benefit of the profits interest is not available in the vast majority of countries and/or the regulatory and tax treatment of the profits interest is not clearly addressed in local laws. Therefore, a cash-settled profits interest unit may be helpful as it represents an unsecured, unfunded promise to make a cash payment to the grantee in an amount that similarly tracks the future growth of the partnership. In most countries, the cash payment would be taxed upon receipt as ordinary income. The regulatory issues must still be reviewed, but if the units can only be settled in cash (and especially if the cash can be paid through local payroll), there are often no significant regulatory issues.

Partnerships looking to go public and convert to a corporation as a part of that process sometimes grant cash-settled profits interest units that may convert into equity awards over shares of the successor publicly listed company. Careful analysis needs to be conducted to determine whether providing for such flexibility in the award would trigger any issues under applicable laws and regulations.

Equity Awards with Immediate Sale Feature

It is also useful to mention the existence of share-settled equity awards with an immediate sale feature. Here, grantees end up with only cash and not shares when the award is settled. These awards are generally seen in the form of a stock option with a mandatory "cashless exercise" or "same day sale" feature or in the form of a share-settled RSU with a forced sale requirement.

This type of award is not considered to be a "cash award" because shares are issued pursuant to the award even if they are held by the grantee for only a moment in time. However, in some jurisdictions, this type of award can address some of the issues associated with equity awards without triggering some of the downsides of cash awards.

Additional Features of Cash Awards

Cash awards do not need to be granted under the company's equity award plan. However, if the company wants to retain any ability to settle an award in shares, then such award generally must be granted under an equity plan. Further, even if it is not necessary to grant cash awards under an equity plan, it may be useful to do so because the plan includes terms and conditions that the company may wish to apply to the cash awards (e.g., related to the administration of the award or treatment upon change in control). This also makes it easy for the terms of the cash awards to be consistent with the terms of share-settled equity awards the company may be granting. In any case, it is desirable to document the terms and conditions of a cash award in an award agreement similar to what is done for equity awards and to have grantees accept the terms and conditions of a cash award.

Cash awards that are intended to replace equity awards are typically granted by the parent company rather than the grantee's employer and, like equity awards, the cost of a cash award may be borne by the parent company or by the grantee's employer. There is flexibility in terms of how a cash award will be paid, as a cash payment may be delivered to a grantee through local payroll or through a brokerage account. As further described below, the decision regarding which entity will bear the cost of the award and which payment method will be used may depend on the issue(s) the company is seeking to address with the use of cash awards.

Benefits of Cash Awards

There are several advantages of offering cash awards instead of share awards.

Avoiding Securities Law Requirements

One of the primary reasons that companies turn to cash awards is that they tend not to be subject to as many securities filing requirements as equity awards. The list of countries where cash awards may avoid such requirements is constantly shifting so these issues should be reviewed on a regular basis.

Currently, securities filings in the Philippines, Malaysia, and Thailand (among others) may be avoided if cash awards are used. However, in Malaysia, if a cash-settled equity award is granted, tax filings (which are arguably more burdensome than the securities filing) still need to be completed. In the United States, if an award can only be settled in cash, the federal securities registration and reporting requirements generally do not apply, although state securities registration requirements still need to be considered.

In some countries, cash-settled equity awards are subject to the same securities law requirements as share-settled equity awards. For example, this is currently the case in

Australia and Canada (although there may be available exemptions from the securities law requirements for both share-settled and cash-settled equity awards in these countries). In a limited number of countries, a different kind of cash award (e.g., where the payment is not dependent on the development of the share price) may be necessary to completely avoid the securities law requirements.

In a handful of countries, a cash-settled equity award could trigger additional or different regulatory issues from share-settled equity awards. In the United Kingdom, there are exemptions from financial services regulations for share-settled awards, but these do not necessarily apply to cash-settled awards. There is often a way for companies to get comfortable that a cash-settled award can be made without running afoul of the financial services regulations. However, the ability for a company to get comfortable with this conclusion will depend on the specific facts and circumstances and should be examined before granting cash-settled equity awards.

For resources that discuss securities law compliance aspects of equity compensation, see the "Securities Law Compliance" heading within the Equity Incentive Plan Resource Kit.

Easing Exchange Control Difficulties

Another significant reason that companies turn to cash awards is to mitigate certain exchange control risks and potentially avoid the applicable requirements. Often, if cash awards are paid locally without the cross-border transfer of funds, they are not subject to exchange control requirements.

The most common example of this is in China where, since 2007, a somewhat costly and burdensome exchange control registration and ongoing filings have been required in order to offer and administer any kind of equity award. For some companies, it is not feasible to complete such a registration—this may be because the headcount in China does not merit the effort or expense or because it is not possible for the company to register its plan/awards for some reason (e.g., the company is private or does not have the right corporate structure to be able to register or the participants are not regular employees but independent consultants or other service providers).

Similarly, a costly and burdensome exchange control registration is required to operate an equity plan in Vietnam and some companies will not be able or will not want to complete the registration.

In both cases, the registration requirements should not apply in practice if a cash-settled equity award is funded and paid locally such that there is no cross-border transfer of funds directly related to the award. This can be problematic if the local entity does not have the funds to cover the settlement of such awards and there is no way for the funds to be transferred into the country.

Addressing Tax Issues

There are a few countries where a cash award may have certain tax advantages.

For foreign companies offering share plans in India, to correctly fulfill tax withholding and reporting requirements, it is necessary to engage a Category 1 Merchant Banker registered with the Securities and Exchange Board of India to determine the fair market value of the company's shares. If the company grants cash awards in India instead of equity awards, a Category 1 Merchant Banker valuation would not be required, and tax would simply be due on the cash payment received (even if it is based on the value of the company's shares).

In some countries, for equity awards, tax may be due prior to the time the shares are actually issued to the participant (e.g., where the risk of forfeiture lapses before the shares are issued) or there may be a lack of guidance regarding the treatment of certain equity awards whereas for cash awards, tax is generally due when the cash is actually paid.

In a few countries, it is still not possible for the local entity to take a local tax deduction for an equity award (even if it reimburses the parent company for the cost of the award) whereas in most countries, if the local entity bears the cost of the cash-settled award, it will be able to take a local tax deduction with respect to that amount.

Even more basic than any of these points, tax withholding is much simpler on a cash award, as there is a readily available source for withholding and the company does not need to worry about whether it can fulfill its withholding obligations by net share settlement, selling shares to cover taxes, deducting amounts from payroll, or requiring a payment from the participant. Further, if the company has mobile employees with awards and withholding is required in multiple jurisdictions, the ease of withholding on a cash-settled award would be advantageous.

When addressing taxation of U.S. employees receiving cash awards or other compensation when performing services outside the United States, identify whether an income tax treaty exists between the U.S. and that other country and the treatment of "dependent personal services" under that treaty. For a discussion regarding the effect of an income tax treaty on dependent personal services, see Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 55.03, "Personal Services Income of Independent Contractors, Employees, Entertainers and Athletes," Employees. For an alphabetical table of U.S. income tax treaties in force, see Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 40.11.

Preservation of Shares

Cash awards do not deplete the company's share reserve. Public companies often face scrutiny in obtaining approval for new share plans and increased share pools due to concerns about shareholder dilution and burn rates. By granting cash awards, companies can preserve shares for strategic grants where a share-settled award is needed or desired.

For example, some companies with broad-based grants may grant cash awards to rank-and-file employees so that they can save shares and grant share-settled awards to targeted groups such as executives who may tend to hold on to shares longer than the general population or who may be required by share ownership guidelines / requirements to hold a certain number of company shares.

Easily Understood and Simple to Administer

Everyone understands a $100 bill. You can hold it in your hand, use it to buy groceries or put it in the bank. On the other hand, equity awards are a "little bit like paying your employees . . . in lottery tickets" says Dirk Jenter, an associate professor of finance at the London School of Economics and the Stanford Graduate School of Business who studies employee attitudes towards equity compensation. See R. Feintzeig, "Do Workers Want Shares or Cash?" The Wall Street Journal (Oct. 27, 2015).

Participants may have trouble grasping the potential upside of equity awards and may not be confident as to the future value of the equity awards. As a result, equity awards require more participant education than cash awards.

Not only do cash awards require less company communication, they require less action on the part of the participant. Cash awards are automatically delivered to the employees through their brokerage account or through local payroll. Participants do not have to track the company's share price to determine the best time to exercise options and they don't have to worry about the best time to sell the shares they have acquired under share-settled awards.

In addition, cash awards are simpler because there is no need to worry about plan or regulatory restrictions. For example, generally, share-settled awards cannot be made to someone who is not a service provider to the issuing company or one of its related entities. On the other hand, if the company needs to grant an award to someone who is not an employee or other service provider for any reason, a cash award can be made without such concern. (In this case, the award would need to be granted outside of the company's equity plan because the plan likely restricts grants to service providers.)

Downsides of Cash Awards / Benefits of Equity Awards

The following is a discussion of the potential downsides of providing cash awards versus share-settled awards.

Impact on Share Ownership

One of the reasons for offering equity awards is to align the interests of employees, and especially executives, with the interests of shareholders, to motivate employees to work toward the good of the shareholders. In the case of a cash-settled award, this alignment only lasts for the life of the award and does not continue past the settlement date as the employee does not end up holding any shares. Share ownership can also provide employees with a pride of ownership and, therefore, greater engagement which is lacking or at least limited with a cash award.

It should be noted that even share-settled awards may not serve these purposes if employees "flip" (sell) the shares immediately upon receipt. However, there is at least some hope of this alignment of interest / pride of ownership and there will almost always be some segment of employees who will hold shares long-term.

On this note, many companies are implementing share ownership guidelines or requirements for employees, at least at the executive level, and cash awards do not help executives achieve these requirements. Instead, these individuals would need to purchase shares on the open market to achieve the required thresholds which is less convenient and creates additional considerations for Section 16 officers, as the open market purchase will be a matchable event for purposes of the short-swing profit rules/restrictions whereas an equity award vesting/settlement will not.

Cash Flow Considerations

One obvious downside of cash awards is they require that a company have sufficient cash on hand to be able to deliver adequate value to participants in cash. Equity awards, on the other hand, can be a great way to compensate or reward employees even when cash is limited (e.g., in a start-up scenario or when cash flows are otherwise low). Further, in the case of a cash-settled award, the hit to cash flow can be major when the company's share price rises significantly. This volatility raises another point about the downsides of cash awards.

Accounting Treatment

Under U.S. generally accepted accounting principles, equity awards have more favorable accounting treatment than cash awards. To put it simply, an equity award appears as equity on the balance sheet (not a liability) and the fair value of the award is measured once at the date of grant (unless the award is modified) and the fixed amount is recognized over the vesting period.

On the other hand, a cash-settled award appears as a liability on the balance sheet (not equity) and the fair value must be remeasured each reporting period until the date of settlement (even if the award is fully vested before then), which creates greater volatility in the income statement. (Note: We are not accountants, so please speak to your accountant about the accounting implications of cash awards versus equity awards.)

Less Favorable Tax Treatment

Equity awards are able to benefit from favorable tax treatment in several countries where cash awards cannot. There are formal tax-qualified regimes for share-settled awards in Denmark, France, Israel, and the United Kingdom, but these do not apply to cash-settled awards. In addition, there are beneficial tax regimes or tax deferrals available for share-settled awards in Belgium, Canada, Estonia, Italy, Poland, Romania, and Spain but, again, these do not apply to cash awards.

Further, in Canada, cash awards can have negative tax consequences depending on the vesting schedule and other factors as they can fall under the "salary deferral arrangement" rules whereas awards that can be settled only in shares typically do not fall under these rules.

Companies should consider whether any of the beneficial tax regimes warrant the grant of share-settled awards rather than cash awards. In certain cases, the benefits to the employer and employee of share-settled awards may outweigh some of the obstacles, such as complying with local securities law requirements.

Impact on Tax Withholding Requirements and Social Insurance Contributions

In many countries, cash awards are more likely to be subject to tax withholding obligations and social insurance contributions than share-settled awards. This is particularly so if the cash awards are paid through local payroll, but even cash awards paid into an offshore brokerage account are more likely to be subject to tax withholding and social insurance contributions than share-settled equity awards.

In Australia, withholding is typically not required for share-settled awards but will be required for cash awards, regardless of whether the cash is paid through local payroll or into a brokerage account. In Japan—where withholding is generally not required for share-settled awards (assuming the local entity is not substantially involved in the administration of the equity plan)—if a cash award is paid into an offshore brokerage account, the treatment is likely the same as a share-settled award whereas if the cash award is paid through local payroll, withholding will be triggered.

In Ireland, cash awards will be subject to (uncapped) employer social insurance contributions while share-settled awards are not subject to employer contributions. Similarly, in Malaysia, cash awards may be subject to employee and employer contributions, depending on certain factors, while share-settled awards are not subject to social insurance contributions. In practice, these contributions in Malaysia are capped and at least some employees will meet the threshold for such contributions based on regular salary. However, the imposition of social insurance contributions is something to consider, especially if the company is considering granting cash awards in Malaysia as a way to save money by avoiding the securities filing.

The list of countries where cash awards are subject to withholding obligations and/or social insurance contributions, whereas equity awards are not, is constantly changing so these issues should be reviewed regularly.

Lastly, in the United Kingdom, some companies transfer the liability for employer National Insurance contributions to employees as a condition to receiving or vesting in the equity award, but it is not possible to transfer this liability with respect to a cash award.

Labor Law Implications

When a foreign parent company offers any kind of award to employees in another country, there is a concern that the award may be considered part of the local employment terms. In many countries, a significant risk is that the award and the related award income may become an "acquired right" or entitlement in which case the company could not cease offering the award (or make changes to the award) in future years or must obtain consent before changing the terms of future awards. In addition, the award income may need to be included for purposes of calculating local mandatory payments (e.g., severance payments).

For cash awards, these labor law risks are increased because the cash payment "looks and feels" more like other aspects of local compensation, especially if the award is paid through local payroll. Conversely, shares of a foreign company do not have the same look and feel as the rest of local compensation.

Because of these risks, companies should keep any parent company award—whether share-settled or cash-settled—as separate as possible from the local employment arrangement. To accomplish this, the award should not be mentioned in the local offer letter or employment agreement and all inquiries about the award should be handled by the parent company. Further, cash awards should be paid into an offshore brokerage account. This may not be possible in countries like China and Vietnam where the payment of cash must be made through local payroll in order to address the relevant regulatory issues. And, in countries where cash awards can be paid into an offshore account, this means that these awards still have some of the same operational burdens as share awards.

Implementation of Cash Awards

For companies that decide to offer cash awards, there are a few decision points as well as administrative considerations. As discussed above, cash awards do not necessarily need to be granted under the company's equity plan, but it may be desirable to do so to benefit from the framework already established under the plan.

To the extent it is not possible or desirable to grant cash awards under the company's equity plan, the company should be sure to incorporate any necessary terms into the cash award. Whether the award is granted under the equity plan or not, an award agreement should be used to document the material terms of the grant and to communicate important information about the award to the grant recipient.

For example, such award agreement should include provisions on award structure (e.g., is the award a cash-settled equity award that mirrors the company's share-settled award, or is the cash amount set at grant or pegged to something other than the company's share price), vesting and settlement conditions (e.g., when and how the award will be paid, how the award will be treated upon a change in control), tax withholding, entitlement, and other labor law issues, data privacy, claw back (if applicable) and other standard contract terms that are normally included in share-settled award agreements. For a discussion of special issues regarding cash awards to employees in the context of a change in control, see Executive Compensation § 6.07, "Change of Control Issues."

Similar to equity awards, provide participants with a brief description of the tax consequences of the award and any local law considerations of which they should be aware in connection with the award (e.g., if the award will be paid into an offshore brokerage account, inform the participants of any exchange control or foreign account reporting requirements that may apply to them in connection with the funds or the account).

Conclusion

Companies considering granting cash awards in place of equity awards should conduct a cost-benefit analysis that takes into consideration their own priorities and areas of concern. Cash awards can help to address some of the issues associated with equity awards but should be treated more as a tool in the company's long-term incentive program toolkit rather than a panacea.

Lastly, cash awards should be treated with similar caution as share-settled equity awards. Counsel should conduct due diligence to determine the relevant regulatory and tax issues associated with such awards and proper grant documentation should be used to protect the company and communicate necessary information to the participant.

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