Fall 2018

VIEWpoint

MANAGEMENT COMPENSATION RESOURCES

Compensation and purpose drives employee loyalty

It's a story as old as time; what each generation wants from their career is different than what their parent's generation wanted. The differences between generations can be significant and as a parent of three young men, I've had my share of first-hand experience with the difference between generations.

The shift in social and economic thinking between generations is significant enough that businesses must address the change in their workplace. No longer the new kids on the block, millennials are joining the ranks of key management employees. This new generation of key employees is driven by different goals and desires than many traditional incentive compensation plans are built to recognize.

Even though competitive salary still comes in as a top priority (68% according to a study by SAP), younger generations want more. They want purpose. This notion of "purpose" versus just compensation really came into focus for me when a young manager (let's call her Sue) articulated what matters to her generation.

"My generation wants to have a purpose, not just compensation. That might mean making the company better for our customers and fellow employees or it might mean the work itself needs a purpose. Competitive compensation, coupled with the 'purpose,' is what I need to be able to hire and retain more people like me."

What has become apparent is that the tried-and-true methods of long-term incentive compensation that worked with Baby Boomers isn't exactly what Sue and her generation is looking for. Plans that pay for "loyalty" to the company, i.e. "stay with us for many years and we will reward you for that service" are no longer relevant. So, what does compensation combined with purpose look like in an updated program?

Loyalty looks different.

Recent studies have shown that loyalty is still important to these generations, just in a different way than those who've come before. The chance to experience new things (new jobs, new ideas, etc.) is a major part of developing loyalty in today's corporate environment. Career decisions are heavily influenced by factors like current compensation and cash flow, work-life balance, a sense of doing good and helping others, and flexibility in work schedules, etc. to help accomplish all of this.

Purpose comes into play in their desire to understand the "why" of what their work means to the company and all of its stakeholders not just the customers. However, there is also a pragmatism in this generation and those members who are now progressing into key business roles know that the "rubber still has to hit the road" in order for the business to be profitable and support everything it is trying to do. So what is a business owner to do? How do you link this new generational thinking to the long-term results of the business?

(*Compensation*, *continued on page 2*)

Divided government isn't such a bad thing...

Although it does reflect a more sharply divided country.

We seem to be evolving into a nation of urban vs. rural voters. That might be overly simplistic, but consider that a Republican now represents the 8th U.S. House District in NE Minnesota - which has only occurred for two out of the last 60 years! And the 3rd District (SW suburbs of Minneapolis) has now swung to a Democrat for the first time since the 1970's.

Overall control of the U.S. House will belong to the Democrats - and likely Speaker Nancy Pelosi. But Republicans (and Majority Leader Mitch McConnell) actually added to their U.S. Senate majority by flipping seats in Indiana, Missouri, and North Dakota. So what does all of this mean for income taxes in the next two years?

Individual income tax rates in the U.S. are low by historic standards; and Democrats in the House will be talking about tax-increases for individuals and businesses. Therefore, tax-deferred retirement savings will continue to be a good strategy. However, Senate Republicans won't approve much that comes out of the House in the next Congress.

The silver lining here is no more political ads for the next 18 months or so – and no bad policies from either party that will get signed into law!

Let's see if either party figures out a way to work with the President – because we already know they can't seem to work with each other. As always, we wish you a wonderful holiday season – and let me know if we can be of service to you or your company. Thank you.

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(*Compensation*, continued from page 1)

How businesses are valued looks the same.

Owners still need reliable (and growing) profits to create long-term value for themselves and all of the company stakeholders. Buyers (or equity markets) will only pay a certain amount for the value that a business generates and profits is how it is measured.

Therefore, a business owner that wants to connect this creation of value to key employee compensation still needs to be able to pass along this longer-term risk to those key employees. Otherwise, the very definition of long-term incentive begins to erode, and the compensation plan gets skewed. In other words, if key employees aren't willing to share in the risk of potentially growing the value of the company (and being paid more IF it grows), then owners will simply keep the risk and not pay those key employees more at all.

But not taking this compensation risk creates a different risk to this new generation of key employees: if owners are "cornered" into keeping all of the risk more of them will simply cash-in and sell the entire business at some point. But anyone who has lived through the sale of a privately-held company to a bigger company (or an investment / private-equity firm) can attest to the fact that such a sale will bring changes that many employees might not be happy with (layoffs, restructuring, closing of locations, etc.)

None of these concepts is really new. Rather, they are being employed in creative ways with the goal of matching the newer generation's needs for flexibility and current rewards.

So how can companies bridge the gap between the older strategy of simply paying at retirement for long-term growth in business value to address the needs and desires of this newer generation without having to outright sell the business? A trend we are seeing in the marketplace has a few main themes:

1. Long-term now includes the concept of "off-ramps" or partial payouts at various points during the career / life cycle of the plan;

2. Options for how the money can be paid back to the key employees abound (paid over 4-5 years to help pay for college education, a lump-sum to help make a down-payment on a home, etc.); and

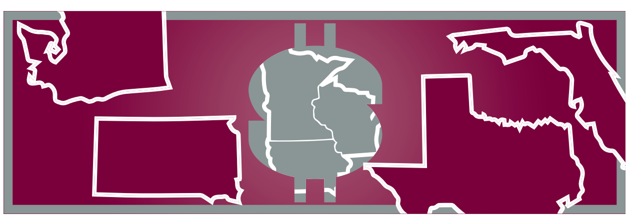
3. There are likely to be some qualitative factors in the Plan formula (compared to a strictly quantitative financial formula) that determines the ultimate payout.

None of these concepts is really new. Rather, they are being employed in creative ways with the goal of matching the newer generation's needs for flexibility and current rewards with the over-arching goal of business owners to keep key employees linked to the growth in the value of the business… which is how owners ultimately get paid. Because some of the long-term risk is removed from the employee side of the ledger these plans will pay less in terms of total dollars to the key employees, which serves to compensate the owners for keeping more of the risk than in previous generations.

Younger employees that recognize this risk-shifting (and are motivated by sharing in some of that risk) will demonstrate to business owners that they really are the kind of thinkers and leaders that will take companies to the next level as us Baby Boomers begin to retire.

Smart business owners need to be aware of these generational changes and continue to devise creative ways to link incentive compensation for key employees to both the purpose and performance of their roles within your organization.

It's a little-known fact



With acknowledgments to Cliff Claven, that master of trivial knowledge from the sitcom Cheers, here is a little-known fact for your reading enjoyment:

Qualified and non-qualified retirement plan payments are taxable as income in the state you legally reside in when the payment is received, as long as the payments are part of a series of substantially equal periodic payments for life, or over a period of 10 or more years.

For some, that statement is as abstract as theoretical physics. For most, it has us thinking, "thanks Cliff but what does that mean?!?" Well, let's assume for a moment that you live in a high income-tax state (like Minnesota, Iowa or Wisconsin). Next, assume you retire and change your legal residence to Florida, South Dakota, Texas, Washington, or another state with no income tax.

If you have qualified / non-qualified retirement benefits that are payable for life, or in installments over 10 or more years, you may be able to permanently defer state income taxes (that's right, never pay state income taxes!) on those retirement plan benefits. This is all governed by a Federal rule, the "Source Tax Law," and as long as you comply with the payment for life (or 10 or more years provision), state law cannot override it.

Here in Minnesota, the "Land of 10,000 Lakes… and 11,000 Taxes" the top marginal income tax bracket is now as high as 9.85% depending on your filing status, which could add up to thousands of dollars in taxes on your retirement benefits! Imagine NOT having to pay some (or all) of those income taxes…

Of course, you would have to move and legally change your state of residence - but it could have a significant tax benefit; along with the different weather and scenery. [This is where our lawyers want us to remind you to consult your personal tax advisor for specific guidance on this issue.]

And who says newsletters don't provide any value?!?! We wish you a happy and healthy holiday season and prosperous New Year ahead in 2019. Please let us know if we can be of assistance to you in the areas of compensation and benefits for key management employees in your organization.

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