

## Considerations for Private Companies in Connection With Implementing Salary Reductions

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As the coronavirus and its economic impact spread throughout the United States and around the world, and volatility continues in the financial markets, many organizations are considering measures such as salary reductions in an effort to reduce overhead, preserve cash and ensure continued operations.

Private companies should be mindful of the considerations and common pitfalls below when implementing a base salary reduction, whether on a limited basis or broadly across the organization.

- 1. Applicable law and impact on other arrangements. When reducing base salary, consideration should be given both to applicable minimum wage laws and minimum employee contributions required to fund participation in various company welfare benefit plans (such as health insurance). Consideration should also be given to ensuring employees receive a sufficient level of base salary to maximize elective contributions to company-sponsored tax-qualified retirement plans. In addition, companies should consider the impact on incentive, severance and other compensation-related plans and programs where payment is based on base salary (e.g., target bonuses expressed as a percentage of base salary or severance programs based on a multiple of monthly or annual base salary), and whether any adjustments to such arrangements should be made.
- Deferrals. It is common to consider accruing, but not paying, base salary on a current basis (i.e., to defer
  future salary and pay it out at a later date). However, unless properly structured, this approach will likely
  result in significant adverse tax consequences to employees under Section 409A of the Internal Revenue
  Code
- 3. Elective reductions. Caution is needed when permitting individuals to elect to reduce base compensation. Such reductions may implicate Section 409A or potentially result in constructive receipt issues, triggering accelerated and/or increased taxes. From a tax perspective, it is imperative that any reduction not be structured as a deferral but instead as a permanent reduction of compensation without any guarantee or binding commitment to reinstate or provide a make-whole payment at a future date.
- 4. **Mandatory reductions.** Implementing a mandatory salary reduction must also be done with care, and companies should ensure that reductions do not inadvertently violate any contractual guarantees or trigger any severance obligations (for example, where an individual has the right to terminate employment for "good reason" and receive severance following a reduction in base salary).
- 5. Cash bonus in lieu of base salary. In certain circumstances, companies may want to provide an employee, either concurrently with or following a salary reduction, the opportunity to receive a cash bonus in connection with the occurrence of a future event (e.g., a financing, transaction or other company liquidity event). These arrangements can be structured so they are exempt from Section 409A, typically by requiring that the employee continue to provide services to the company (or a successor) through the event or date triggering payment of the cash bonus.
- 6. Additional equity awards. Additional equity award grants are often considered for retention following a salary reduction. To avoid adverse tax consequences, these awards should not be characterized as replacing previously earned and unpaid base salary amounts.
- 7. **Non-US employees.** Rules regarding reduction of compensation for non-US employees vary from country to country and reduction may not be permissible in certain jurisdictions. It is therefore important for companies to consult with their advisors before implementing a reduction program in any applicable non-US jurisdiction.

Also see our article on reducing personnel expenses in an uncertain economy.

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