Executive Compensation

Equity-Based Incentives

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The use of equity as a key component of executive compensation is probably the most difficult and controversial issue to manage by the compensation committee of a corporate board of directors. In theory, equity-based compensation should drive management to behave in a manner consistent with the wishes of the shareholders. This column focuses on the three most prevalent equity awards.

Nonqualified Stock Options

Nonqualified stock options (NSOs) are by and large the most common equity incentive arrangement. Executives may buy stock at a specified price (grant) for a given period of time. Compensation derived from the appreciation in the stock price between the option grant date and the option exercise date is taxed at ordinary income tax rates. NSOs can be exercised in any sequence.

There is no taxable income to the executive triggered by the option grant. Appreciation from the grant price is taxed at ordinary income tax rates upon exercise. For example, a grant price of $50 and an exercise price of $75 create ordinary income of $25. The company is required to withhold an executive's taxes at exercise. This can be a problem because the exercise of the option itself does not generate cash for the executive. When the executive sells the stock, any future appreciation from the exercise price to the sale price is taxed at capital gain rates.

There is no tax deduction for the company as a result of granting an option. The company does receive a tax deduction equal to the executive's ordinary income when the option is exercised. There is no impact on the company from any subsequent sale of the stock by the executive.

Advantageous to users of nonqualified stock options is the idea that such arrangements are an attempt to align executive interests with shareholder interests. There are no limitations on the amount that may be exercised. Nonqualified options are less dilutive than incentive stock options and the nonqualified variety offer potential for long-term appreciation as the company grows. The disadvantage of a nonqualified arrangement is that executive investment is required at two different intervals—first, to acquire the stock and second, to satisfy the tax liability. Also, NSOs dilute earnings per share through common stock equivalents.

There is no charge to corporate earnings unless the option price is variable or is less than 100% of fair market value on the grant date, or unless the company has elected to account for stock options under FASB 123. Where FASB 123 is used, there is a charge to earnings that is calculated based on the estimated fair market value at grant date using an option pricing model.

Incentive Stock Options

Incentive stock options (ISOs) are option plans that meet the guidelines of IRC Sec. 422. They must be granted to employees with an exercise period not to exceed 10 years. The grant price cannot be for less than fair market value at the time that the option is granted, and the option cannot be transferable. ISOs with an aggregate value of $100,000 cannot be granted to be first exercisable in any given year.

The executive incurs a tax liability only when stock obtained through an ISO is sold, and not when the option is exercised. Thus, gains are treated at capital gain rates, provided the executive does not dispose of the stock until the later of two years from the grant of the option or one year from receipt of the stock. As ordinary income tax rates increase, ISOs become more attractive to executives because the tax is deferred until the stock is sold.

The company receives no tax deduction upon exercise, which can make ISOs an expensive equity vehicle to offer from a company point of view. However, if the company is in a low effective tax bracket, the lack of tax deductibility may still be a fair trade for the benefit provided to the executive.

A major ISO advantage is that the executive has control over the timing of the taxable event (sale of stock and not exercise of the option). This provides the executive an opportunity to do better long-term tax planning, including the ability to defer income without taxation and possibly pay taxes at the lower capital gains rates. From a company perspective, the main disadvantage of an ISO arrangement is the lack of a company tax deduction when an executive exercises an ISO. From the

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executive's point of view there are two disadvantages. The first one is the holding period of ISO shares: the longer of two years from grant or one year from the receipt of the stock in order to receive capital gains treatment. The second disadvantage is that the executive is limited to being granted ISOs of up to $100,000 that are exercisable for the first time in any given calendar year.

Finally, ISOs that have not been exercised are considered common stock equivalents and are factored into the determination of earnings per share, and they can have a dilutive cost impact on the company's earnings per share and balance sheet if the stock price appreciates.

Restricted Stock

Restricted stock is an outright grant of shares to executives. This outright transfer of stock has restrictions as to the sale, transfer and pledging of the granted shares that lapse over a period of time. The restrictions can be for three or five years or for whatever time period is desired by the company. As the restrictions lapse, the executive has an unfettered right to sell, assign, pledge, encumber or do whatever he or she desires with the shares. However, if the executive terminates employment all unvested shares are forfeited. During the restriction period, the executive will receive the dividends on the restricted shares and also be able to vote the shares.

To the executive, no individual income tax liability occurs when the restricted stock is granted. As restrictions lapse, the current market value of vested shares is taxed as ordinary income. Dividends received during the restriction period or otherwise are taxed as ordinary income.

For the company no tax deduction is permitted when the stock is granted. As restrictions lapse, the company receives a tax deduction equal to the executive's ordinary income. There is no tax deduction at sale. Note that dividends paid during the restriction period are deductible when paid. The foregoing tax impact to the executive and company assumes that a Sec. 83(b) election is NOT made. If a Sec. 83(b) election is made, the executive recognizes income on the date the restricted stock was issued, and the company receives an immediate tax deduction for the initial value of the shares (but not for the subsequent appreciation during the restriction period).

The advantages of a restricted stock arrangement are that no investment is required on the part of the executive and immediate stock ownership is promoted. The charge to earnings is fixed as of the time of the grant. If the stock appreciates, the company's tax deduction will exceed the fixed charge to earnings. Restricted awards also offer executives potential long-term appreciation as the company grows with more of an alignment to shareholders than either ISOs or nonqualified options.

The disadvantages to restricted stock arrangements are that there is a charge to earnings and an immediate dilution of earnings per share. The executive may incur a tax liability before the shares are sold, requiring him or her to use other funds to pay his or her tax liability. If the stock goes down in value, the company's fixed earnings charge would exceed its tax deduction.

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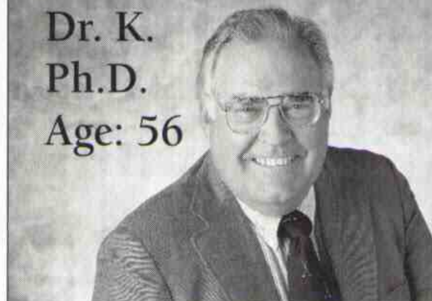

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Which Equity Awards?

Most companies don't pay as much attention as they should to how awards are granted. Boards of directors and the executives just want a plan in place, the details of which are thought to be negligible. The problem with this line of thinking is that each type of award has its own pluses and minuses. Stock award plans are not interchangeable. NSOs and ISOs and restricted stock should be compared and contrasted in light of the retentive, incentive and financial goals of the company. By turning over the design of an award plan to consultants and Human Resource departments, directors and executives have no idea what alternatives exist. Why is this important? Because the way awards are granted has an enormous impact on a company's efforts to achieve its business goals. Equity awards can be allocated under three different categories. These three categories of equity awards entail very different incentives and very different risks.

Fixed-Dollar Awards

Fixed-dollar awards provide that executives receive an option or restricted stock award of a predetermined dollar amount every year over the life of the plan. Fixed-dollar awards are probably the most utilized equity award arrangement. They are popular because the use of a fixed-dollar award allows a company to carefully control the compensation of executives and the percentage of that compensation derived from equity awards. Consequently, fixed-dollar awards are ideal for companies that set executive pay according to studies performed by compensation consultants. By adjusting an executive's pay package each year to keep it in line with other executives' pay, a fixed-dollar award assists in minimizing executive retention risk.

Fixed-dollar awards have a huge disconnect between shareholders and management. The disconnect is from fixed-dollar awards setting the value of future grants in advance, thereby weakening the link between pay and performance. Under a fixed-dollar award system, executives end up receiving fewer options/shares in years of strong stock price performance and more options/shares in years of weak stock price performance.

Fixed-Unit Awards

Fixed-unit awards stipulate the number of options or shares the executive will receive over the plan period. Fixed-unit awards have a stronger link between pay and performance than a fixed-dollar award. Since the value of at-the-money options changes with the stock price, an increase in the current stock price increases the value of future option grants. Likewise, a decrease in stock price reduces the value of the option/stock award. Since fixed-unit awards do not insulate future pay from stock price changes, they create more powerful incentives than fixed-dollar awards.

Megagrants

Megagrants are not as common as fixed-dollar or unit option awards in established firms but are widely used in private companies and post-IPO companies. Megagrants create leveraged executive wealth because they not only fix the units in advance but also the exercise price of the options. While executive wealth is leveraged, shifts in stock price have a dramatic effect on a holding this large.

Summary

Equity incentives figure as the single largest component of senior executive pay. Most importantly, equity awards are the mechanisms that link executive pay to the fortunes of shareholders. In a properly designed executive compensation package, superior shareholder value creation results in executive wealth. Likewise, poor shareholder returns correspond to below-par compensation for executives.

The choice among awards involves a complicated trade-off between providing strong incentives today and ensuring that those incentives exist tomorrow...especially if the company's share price falls precipitously. ■

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