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The Equity Component of the Executive Compensation Package

An ownership position which established an economic basis for equating executive interests with corporate goals is fundamental to compensating the executive, whose responsibilities exert a basic economic effect on business outcomes. While the last fifteen years have seen the development of imperfect relationships between market valuation of corporate equities and actual business outcomes, corporate officers and directors continue to recognize ownership as the ultimate long term incentive.

Executive Compensation in the 1980s

Workable methods for conveying ownership to professional executives were developed in the 1950s and broadly applied during the 1960s. The utility of these methods diminished during the 1970s as important changes occurred. Public equities markets often failed to accurately mirror business performance in the evaluation of corporate shares. Changes in tax law, with the Internal Revenue Acts of 1969, 1971 and 1976, influenced the accounting and tax treatment of stock options. These developments led corporations to adopt a variety of deferred variable bonus plans (such as performance units). Large-scale, deferred-cash-payment executive compensation systems advanced rapidly through the 1970s and for a time seemed to obscure the importance of stock ownership programs. By the end of the 1970s, the value of large, deferred-variable-bonus compensation plans achieved perspective for their worth as a hedge against the potential for public equity markets to inaccurately reflect the value of corporate performance, rather than as an ownership replacement. Along with the development of this balanced understanding, the ability of corporate equities to reflect business value was somewhat restored. Smaller corporations became less reliant on public markets as the sole means for evaluating their shares, which were, with some frequency, priced by the acquisition actions of larger corporations.

The late 1960s through early 70s was a period of turning away from the use of stock ownership plans as a key executive compensation method. The period of the late 1970s through early 80s finds renewed interest in locating ways to effectively place ownership interests with key executives. Accompanying renewal of interest are the tax laws and accounting rules of the 1970s which complicate the conveyance of ownership for both corporation and executive. Rather than serving as a valuable incentive and financial privilege, an improperly structured equity interest can become a financial burden for the executive recipient. For the corporation, a sound approach can produce tax advantages and control over profit-and-loss charges. Unsound designs may yield no tax benefits and potentially dangerous, open-ended profit-and-loss charges.

The balance of this article will discuss methods of delivering equity to executives which fit 1980 circumstances, and will explore how appropriate designs can be developed which consider ownership structure, current equity values, size of the equity interest to be conveyed, corporate financial needs, executive financial circumstances and needs, and regulations regarding accounting, reporting, and tax treatment of ownership compensation programs. This discussion will give particular attention to methods of transfer of equity interest to key executives as they apply to the circumstances of:

- the corporation whose shares have not yet achieved a substantial market value above their initial worth;
- the privately held company whose shares have achieved a substantial value above their initial worth; and
- the publicly held company whose shares have achieved an established value in the marketplace.

Choices

Is the Qualified Stock Option Dead? Yes and no! The Internal Revenue Act of 1976 ended the qualified option and it has not been possible to establish new qualified plans since May 20, 1976. However, a corporation which established a qualified plan prior to that date which is still funded with shares may use the plan until May 21, 1981. An option meets the criterion for qualification if it is priced at full market value at date of grant, and does not exceed a five-year period. Qualified options must also be exercised in order of issue.

Qualified options entitle the executive to a future purchase of company stock at today's market price. The executive holder enjoys the benefit of holding the option without tax effect or acquisition expense while waiting to see if the stock appreciates in value. Prior to the Internal Revenue Act of 1969, qualified options exerted no tax effect on the holder when exercised and thus provided the unique benefit of "free holding" after exercise while the executive waited to see whether the stock he had acquired would appreciate in value. The Internal Revenue Act of 1969 established the principal of tax preference for the gain element of a qualified option upon exercise. This treatment was subsequently adjusted by the Revenue Acts of 1971 and 1976. Depending on the executive's financial status and tax bracket, tax preference treatment may be more advantageous than personal service income tax treatment for the gains achieved through stock options. The key is in the tax preference exemption, that is, the amount of the income which is not taxed. This exemption is the higher of $10,000 or one half of taxes due on all other income. The balance is taxed at 15 percent. The other component of tax preference treatment is a dollar-for-dollar transfer of income from earned tax treatment to unearned tax treatment. Option size, option gain, executive income, and tax bracket all play a role in determining whether or not qualified treatment is advantageous or disadvantageous compared to nonqualified treatment (see Table 1).

As illustrated, the qualified option has no tax burden to the executive at time of option grant. When the option is exercised and shares are acquired at the option price, the spread between the price of the shares acquired and their market value at acquisition is a tax preference item. This expense is fixed at exercise regard-

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The information in this article is drawn from the Growth Resource's 1980 *Small Company Officer Compensation Report,* an 136-page report on executive compensation, and is presented with the permission of Growth Resources, Inc.

Table 1. Potential Advantageous and Disadvantageous Applications of the Qualified Option

Advantageous
Executive situation married, filing jointly, two children
Salary $20,000
Effective federal tax rate after deductions 15%
Option gain at exercise $20,000
Option gain at sale $20,000
Shares held three years after acquisition

Qualified Treatment

Gross gain:		$20,000
Preference Tax on	$20,000 gain	
less	$10,000 exemption	
	$10,000 subject to preference tax at 15%	1,500
		$18,500
Income tax at capital gain rates		1,600
Net gain		$16,900

If Nonqualified

Gross gain:	$20,000
If taken as income in year of exercise, raises executive tax bracket to 32% for tax of	6.400
	$13,600

Disadvantageous
Executive situation
Salary $400.000
Effective federal tax rate 50%
Option gain at exercise $500,000
Option gain at sale $500,000
Shares held three years after acquisition

Qualified Treatment

Gross gain:		$500,000
Preference tax on	$500,000 gain	
less	$200,000 exemption	
	$300,000 subject to preference tax at 15%.	45 000
Additional income tax incurred to dollar transfer of income from earned to unearned rates $400,000 taxed at 70% rather than 50% for additional income tax of		80,000
Capital gains tax on $500,000 gain at 28%		140,000
Total tax		265,000
Net gain		$235,000

If Nonqualified

Gross gain	$500,000
Income tax	250,000
Net gain	$250,000

Nonqualified treatment also provides a compensating corporate deduction, and one year holding for capital gains treatment (versus three year qualified holding requirement)

less of price movement which might occur in the stock after the option has been exercised and the shares acquired.

For capital gains eligibility, shares purchased through a qualified plan must be held three years after acquisition. This situation can set up a perilous circumstance for the executive electing to hold qualified shares which may be subject to volatile downward price movement, as the tax preference expense is fixed at option exercise and cannot be recouped even if the transaction ultimately produces a loss.

Nonqualified Options. The nonqualified option has become the prevalent option design since the Tax Reform Act of 1976. Like the qualified option, the nonqualified is the right to purchase shares in the future, at a fixed price determined at time of grant. Nonqualified options may be priced at market or below market price at time of grant. The length of the holding period for nonqualified options is not regulated by law. In practice,nonqualified options are frequently granted for holding periods of as long as ten years.

Nonqualified options provide the executive recipient with the ability to hold a right for future purchase of shares at a predefined fixed price without incurring any immediate expense for holding that right. There are no immediate tax effects to the executive at the time of grant, except in very unusual cases in which the option itself can be shown to have a readily ascertainable market value at time of grant. At the time the option is exercised, the spread between the option price and the market price is taxed as earned income.

The gain achieved by the executive holder of a nonqualified option is taken as compensation expense by the corporation and charged in the corporation's profit-and-loss statement. If discounted, the spread between the discount price of the option shares and their market value is charged as prorated expense. Corporate compensation expense for nonqualified options is tax deductible. A Massachusetts corporation, for example, paying federal income tax at 48 percent and state income tax at 9 percent has a 57 percent government subsidy for cost of its compensation expense to the executive. However, a publicly held company counting on a favorable stock market evaluation of its shares to support an ongoing capital acquisition or business acquisition program could be damaged by large and open-ended profit-and-loss charges which can result from the exercise of a large number of nonqualified shares at high gain to the holders. The balance sheet effect of the exercise of a nonqualified option is an increase to paid in capital for the price paid and an increase in the number of shares outstanding.

Nonqualified options require the option holder to finance purchase at the time the option is exercised. A decision for a long holding period combined with potential for volatility in the market price of the stock and today's high interest rates can combine to have perilous effects in this situation when large numbers of shares and high dollar values are involved.

Stock Appreciation Rights. Stock appreciation rights are frequently granted to alleviate the executive financing burden of nonqualified options. Rights are frequently used in combination with nonqualified options. In this design, the executive is granted an equal number of nonqualified option shares and stock appreciation rights and has the choice of either acquiring shares or exercising his right to receive the gain in the value of the shares since time of grant in cash. Stock appreciation rights and nonqualified options are frequently used in this combination, and the immediate cash proceeds of the rights are used to finance the purchase and tax expense associated with acquiring nonqualified shares.

Executive gain through stock appreciation rights is taxed as personal service income in the year of receipt. The 50 percent maximum tax on earned income applies. The corporation incurs a tax deductible compensation expense which is reflected in the profit-and-loss statement. The balance sheet has no effect as there is no change in paid in surplus or outstanding shares.

Stock appreciation rights are a vehicle for providing executive rewards for growth in the value of company shares without the associated burdens of financing the purchase of shares. In this respect, they are a valuable and convenient compensation device. Rights provide compensation which is related to growth in stock values but do not convey ownership to the recipient.

Performance Shares. Through a performance share plan, corporation stock is granted to participating executives when business performance meets predefined criteria. Performance share formulas are customarily based on business growth, earnings-per-share growth, and the achievement of other specified business goals.

The value of stock received through a performance share program is taxed as personal service income in the year of receipt. Shares held after receipt qualify for capital gains treatment in accordance with normal holding provisions. The corporation reports a tax deductible compensation expense on the profit-and-loss statement in the year award is made. Where shares are granted through a performance share plan, the balance sheet reflects an increase in the number of outstanding shares.

Restricted Stock. Restricted stock are shares "granted" (given or sold) to an employee subject to specific restrictions, such as period of service. Restricted shares are frequently granted without cost and thus overcome initial financing burdens associated with stock option plans. Shares conveyed through a restricted stock plan become the unrestricted property of the executive participant when restrictions are met. During the restriction period, the executive may exert control over the voting and dividend rights of the shares.

At the time restricted shares are conveyed, the recipient may choose to report the spread between the price of shares (if there is any) and their market value as ordinary income. If this election ("Section 83") is made, the executive's tax basis in the shares is their market value at the time of the 83B election. The shares then qualify for capital gains treatment in accordance with normal holding provisions. The executive recipient of restricted shares may elect not to declare the spread between the price and

Table 2. Equity Alternatives

	Qualified Options	Nonqualified Options	Stock Appreciation Rights
Characteristics	Right to purchase shares in future at fixed price determined at the time of grant Available for use to 5/81 if pre-existing plan is in force Complete P&L protection Fixed 15% tax preference charge on exercise, but "free-holding" after payment of tax preference	Right to purchase shares in future at fixed price determined at time of grant May be priced at grantor's discretion and option may extend for any period Gain taxed as regular earned income Deductible to corporation as compensation expense Conveys right to acquire ownership of any size without immediate cost or tax effects Provides deductible compensation expense when executive achieves gain	Grant of rights in the appreciation of company shares during a defined time period Means of conveying direct cash income without complex financing or tax effects geared to growth and value of company shares
Applications	Means of conveying rights in an ownership interest without any immediate cost or tax effects on either side Applicable where P&L needs protection and no tax deduction is required Tax efficient for low-income executives, particularly when smaller interests are being conveyed	Applicable where tax deductible compensation expense is desirable and when size of grant makes expense of share purchase and executive tax liability feasible relative to total executive income Most cost efficient all-around equity conveyance tool Financing may present problem for option holder when large amounts are to be conveyed	Frequently used together with nonqualifieds to assist with financing burden of nonqualified options

	Performance Shares	Restricted Stock
Characteristics	Shares granted outright as compensation, to reward the achievement of predefined goals	Shares granted subject to specific restrictions, such as period of service May be priced at grantor's discretion, at market, below market, or as an outright gift Shares become unrestricted property of the executive after restrictions lapse Value of grant (spread between grant price and market price at time of grant) may be declared outright as income (Section 83B election), thus freezing corporation's compensation expense and executive tax basis in shares at time of grant or granted at market value for similar "fixed basis" effect
Applications	Provides short-term incentive effects of rewards for current achievement, with long-term interests resulting from ownership Augments existing ownership positions For compensation purposes, isolates the performance of an individual division in multi-business unit companies	Particularly useful when large conveyance of ownership is needed, when shares have already achieved a high dollar market value, or both Immediate conveyance of property provides strong retention inducement Valuable to overcome financing problems where flexible pricing and flexible tax treatment aspects of restricteds can be used to advantage

market value of the shares at the time the restricted grant is made. If this choice is made, the executive incurs no initial cost for holding the shares. However, the entire gain at the time the restriction lapse is taxed as personal service income.

If Section 83 is elected, the corporation treats the executive's gain as a compensation expense in the year the restricted shares are conveyed. The extent of this expense is the difference between the price of the shares to the executive and their market value at time of grant. This is a known expense, and can therefore be controlled by the corporation. If the executive does not elect Section 83, the corporation incurs a tax deductible compensation expense equal to the entire gain when restrictions lapse. The expense incurred is the difference between the price of the restricted shares and their market value at the time of restriction lapse. This is a nonpredictable expense and can present a possibility of an open-ended profit-and-loss charge. This problem can be avoided through 83B election or by pricing restricted shares at their full market value at time of grant.

Choosing

Qualified Options. As we leave 1980, existing qualified option programs still have a period of life, expiring on May 21, 1981. If an appropriate number of shares still reside in a preexisting qualified plan, a qualified grant may still be used as a valuable device free of corporate profit-and-loss effects and without initial cost or tax effects on either side for conveying ownership interest to company executives. Qualifieds are cumbersome and present complete tax and financing problems when used to convey large ownership interests or when granted to high tax bracket executives. They remain tax efficient to the recipient when small quantities of shares are conveyed to lower tax bracket recipients and are particularly appropriate for the granting corporation who seeks to protect its profit-and-loss from any compensation charges associated with the option.

Nonqualified Options. The nonqualified option is today's general-purpose equity conveyance tool. The nonqualified, however, presents problems when it is used to convey a large equity interest in a corporation whose shares have already achieved a substantial value. For example, a corporation wishing to convey shares of $100,000 in market value to a key executive through a nonqualified option hands the executive $100,000 financing problem if the nonqualifieds are priced at market. If the corporation seeks to relieve the executive of the financing problem by pricing shares below market, the executive is handed a substantial tax liability in his requirement to report the spread between the price of the optioned shares and their market value at time of exercise as income. When used to convey large equity interests, market value nonqualifieds are most manageable in the environment of the company whose stock has not yet achieved a value so great as to create impractical financing problems.

Stock Appreciation Rights. Stock appreciation rights are one way to alleviate the financing burden presented by nonqualified options. Rights granted in equal numbers with nonqualified options can be designed to provide the option holder with the choice of exercising either an option or a right for each option share held.

Performance Shares. Performance share plans provide a means for combining the short-term effect of rewards for the achievement of current business performance goals with the long-term interest resulting from ownership. Performance share programs are particularly well applied in management compensation systems where executive participants have already achieved the desired primary ownership position. Performance shares can then be employed to fund an incentive plan and augment executive ownership. Performance share plans have great flexibility and are particularly useful in multibusiness unit companies, where overall corporate performance may not accurately reflect the performance of a unique decentralized business unit.

Restricted Stock. Where substantial stock values have been achieved and a need for a large conveyance of ownership exists, restricted stock is a vehicle with attractive potential. Through a grant of restricted shares, rights in a substantial interest of a company can be transferred with no initial cost to the corporation or to the executive. Current restrictions protect the corporation from irrevocable conveyance of shares if the executive does not remain with the firm or meet other specified conditions of the restriction. The executive is assured that the conveyance will occur if he does meet the conditions of the restricted share grant. By granting restricted shares at market value, or by taking an 83B election on grants below market value, the executive receiving restricted shares can immediately begin to qualify the shares for capital gains treatment without grave tax or financing problems. For the corporation, market value grant of restricted shares or an 83B election for below market grants, freezes the profit-and-loss effect of the restricted share grant, which can be then planned and budgeted. From the executive side, a portion of restricted shares can be sold with advantageous capital gains treatment as restrictions lapse, thus financing the cost and tax effects of acquiring ownership.

Summary

Almost, but not quite dead, qualifieds may be a viable choice in circumstances in which there is:

- an existing plan;
- an adequate number of shares in the existing plan;
- a unique situation in which the income level and tax bracket of recipient executives make qualified tax treatment advantageous or where company profit-and-loss needs complete protection from compensation charges.

Nonqualifieds are the general purpose option vehicle for the 1980s. Nonqualifieds can present awkward financing problems when large ownership interests are being conveyed in shares that have already achieved a substantial market value, including:

- a need to report any spread between option price and value at time exercise as earned income;
- a need for one-year holding after exercise often under perilous market circumstances at today's high interest rates in order to achieve capital gains treatment;
- high exercise costs when nonqualifieds are offered in large numbers by a company whose shares have already achieved a substantial price.

Because of their direct profit-and-loss deductibility as a compensation expense, nonqualifieds are very cost efficient to the granting corporation. Financing problems of nonqualifieds are minimized in the small, private, new, young, or undervalued company where shares have a low market value (or, in the case of the private company, can be defended to the IRS as having low market value).

Stock appreciation rights, also a useful vehicle (particularly valuable in combination with nonqualified options), provide some relief from the onerous financing burdens of nonqualifieds. When mixed with nonqualifieds, stock appreciation rights also offer a means for financing the acquisition of nonqualified shares. Stock appreciation rights provide great flexibility. They result in cash compensation, however, and are not useful in fulfilling a corporate goal to place ownership with key executives.

Performance shares are best suited to the established corporate setting where major ownership positions have already been established. They augment existing ownership and provide current incentives for goal achievement. Performance shares use the incentive value of stock twice: once for short- and intermediate-term motivational impact, and once for strengthening the executive's ownership position and corollary involvement in the long-term goals and purposes of the corporation.

Restricted stock provides: flexibility in pricing; an opportunity for the immediate conveyance of shares with an attendant strong retention inducement; gradual conveyance of shares as unrestricted property of the executive holder timed to the gradual pace of restriction lapse; optional (Section 83B) election for restricted shares that provides flexible tax treatment for both executives and corporation; no immediate tax consequences and a fixed basis for executive gain and corporate profit-and-loss charges when restricted shares are granted at market price. Often overlooked, restricted shares are a flexible and financible vehicle and may often be the best available choice for conveying large equity interests to key executives in the environment of an established business whose shares have already achieved a substantial market value.