# Successors to the qualified stock option

*Recent tax legislation has caused a shift in corporate attention to nonqualified options and incentives like 'phantom' stock*

*James F. Carey*

The qualified stock option once had a great vogue, but the tax law changes have put an end to the low-tax treatment it afforded. Nonqualified options are an obvious second choice. But there are other option-like approaches that also tie rewards to the company's long-range performance. They include stock appreciation rights, "phantom" stock, participating units, and performance shares. This article reviews these types and their application.

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The qualified stock option was killed when Congress passed the Tax Reform Act of 1976, and the search goes on for something to replace it. Companies with qualified option plans existing as of May 20 of that year may continue to grant options, but they must be exercised or expire by May 21, 1981. All options exercised after that date will be treated as nonqualified options even if they were qualified when granted. Options under any plan adopted after May 20, 1976, are nonqualified.

Thus ends the opportunity for corporate executives to acquire stock holdings at low risk and with favored tax treatment. Also ended is the most expensive free lunch ever to gain wide popularity.

Surveys estimate that up to 90% of companies with sales exceeding $100 million have granted qualified stock options. Even before Congress acted, however, this type of fringe benefit was losing its popularity as a long-term incentive for executives. Of stock option plans established since 1973, more than half have been nonqualified plans. The movement away from qualified options developed out of depressed market conditions, which left many participants holding options at far over the current market price of the stock and with little hope of recovery before the options expired.

Companies could grant new, lower-priced options; but regulations required that before the executive could exercise a new qualified option, he or she must exercise any prior qualified option at a higher price or else permit its option period to expire. The market, combined with the sequential exercise rule for

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qualified options, therefore focused attention on nonqualified options as replacements for qualified options that had lost value.

In those days before the 1976 legislation, the executive receiving a nonqualified option welcomed an opportunity to get out of the "under water" qualified option and into an attractive opportunity for gain—with additional advantages in flexibility of plan design and administration. The option period could not exceed five years for a qualified option, but the nonqualified option might extend to ten years, thereby increasing the likelihood of gain. Where the qualified option could not be priced below fair market value, the nonqualified option, unaffected by such IRS rules, could be granted as far below market value as the state corporation commission and the stockholders would tolerate. Additional nonqualified options could also be granted at any time without concern for a sequence-of-exercise rule.

In order to get special tax treatment, the executive who purchased stock under a qualified option had to hold the stock for three years (perhaps paying interest on a purchase loan) before selling. But the nonqualified option, offering neither special tax treatment nor special holding requirements, permitted him to sell at any time (subject to the SEC regulation prohibiting an insider from profiting from a buy-and-sell or sell-and-buy within six months). Stock acquired under a qualified option and sold in less than three years reverts to nonqualified status, with the participant's and the employer's tax treatment changed accordingly.

Although the nonqualified option looked good in many respects, it lacked the magic of favored tax treatment that had long enhanced the qualified variety. With a nonqualified option, the difference between the option price and the market price at the time of exercise was taxed as earned income in the year of exercise, although any subsequent gain on sale of the stock was taxed as a capital gain. Under a qualified option, however, the entire appreciation between option price and selling price was treated as a capital gain, taxable when the executive sold the stock.

He was usually better off with capital gains, if the strictures of qualified option regulations permitted *any* gain. (Never mind that capital gain income had already lost much of its charm through earlier tax law changes—and was to be brought even closer to earned income under the 1976 law.) The IRS seemed to favor executives with its treatment of qualified stock options. Albeit severely constrained by regulations, the qualified option looked like an answer to man's timeless search for something for nothing.

**Exhibit I**
Comparing option plans
(Option price $10, options exercised and sold at $30 market price)

| | | Option profit (cost) | Cash bonus (cost) | Tax benefit (cost) | Net |
|---|---|---|---|---|---|
| **Plan A** Qualified option 1 share | | | | | |
| Executive | | $ 20 | | $ (7)* | $ 13 |
| Company | | (20) | | | (20) |
| **Plan B** Nonqualified option 2 shares | | | | | |
| Executive | | 40 | | (20)† | 20 |
| Company | | (40) | | 20 | (20) |
| **Plan C** Nonqualified option 1 share plus cash bonus equal to gain on option | | | | | |
| Executive | | 20 | $ 20 | (20)† | 20 |
| Company | Noncash | (20) | | | (20) |
| | Cash | | (20) | 20 | 0 |

*Assumes 35% capital gain tax rate
†Assumes 50% earned income tax rate

## Rise of the nonqualified

Alas, lurking behind the illusion was the reality of that first law of economics: there is no free lunch. The participant's favored tax position had been bought at a high cost to his company: the IRS prohibited treating as a business expense any part of the executive's gain. This anomaly, a nondeductible form of compensation, cost more in corporate taxes than it saved in individual taxes.

By way of cost comparison, a tax-paying corporation could afford to substitute nonqualified options for twice as many shares as were optioned in the qualified form—at no added after-tax cost to it and no added dilution of earnings per share (EPS). The problem was in convincing stockholders that two equals one. Alternatively, a supplemental cash bonus equal to the option gain could be paid in exchange for converting from qualified to nonqualified mode—with no stockholder approval required. *Exhibit I* shows outlays and benefits of these approaches.

**Exhibit II**
Financing an option

| | | Executive receives (pays) |
|---|---|---|
| January 2, 1978 | Option grant: 5,000 shares at $20 | $ 0 |
| January 2, 1983 | Exercise option: buy 5,000 shares at $20 when market is $50 | (100,000) |
| | Tax on gain at purchase (5,000 shares x $30), at 50% earned income rate | (75,000) |
| | Borrow $175,000 at 8% interest to pay purchase price and tax | 175,000 |
| January 3, 1984 | Sell 5,000 shares at $60 | 300,000 |
| | Tax on gain since purchase (5,000 shares x $10) at 35% capital gain rate | (17,500) |
| | Repay loan | (175,000) |
| | Interest on loan (net of tax) | (7,000) |
| | Net after-tax gain | $ 100,500 |

In spite of the remarkable cost disadvantage, the qualified option bandwagon rolled on with great momentum, and options became an accepted—and expected—part of executive compensation. The cost did not seem to matter; it was, after all, contingent, future, and hidden. Granting a qualified option at current market value had no effect on the income statement or balance sheet. The company obtained today's motivation in exchange for tomorrow's low-risk opportunity for gain.

If the stock price rose and the executive exercised his option, even that event had no effect on the income statement. The option exercise was reflected only on the balance sheet, with an increase in shares outstanding and an increase in paid-in capital (the executive's purchase price). The EPS dilution was little noted in the warm glow of a rising stock price.

Offering much the same low visibility in proxy statements as did the qualified option, a nonqualified option grant at market value produces no immediate effect on the income statement or balance sheet. An option set below current market price, however, establishes an initial compensation expense equal to the difference between option price and market price at the time of grant. But that expense may be accrued over the period of related service.

In accordance with the treasury stock method of computing EPS, an option dilutes earnings per share if the stock price rises. When the executive exercises the nonqualified option, the income statement shows no effect, while the balance sheet shows an increase in number of shares outstanding, an increase in paid-in capital, and a credit to capital surplus for the tax benefit attributable to the difference between option price and market price at the time of exercise.

Stock option gains, qualified or nonqualified, add nothing to officers' direct remuneration reportable in the proxy statement, although a separate paragraph must summarize stock options granted. The IRS rarely challenges the reasonableness of option gains as part of allowable compensation. Thus nonqualified options offer superior cost effectiveness over qualified options, while showing (as with qualified options) a low profile to the outside world.

The inside world, however, pays close attention to them. Among executives and other employees, stock options take on values that transcend monetary return. They symbolize status and affiliation. Options clearly encourage executives to stay and help their companies prosper. Little wonder that more than half the larger U.S. companies have adopted nonqualified option plans, and the number grows daily.

From the participant's viewpoint, the option grant may seem like a no-risk wager in a game of craps called "the market." If the executive stays in the game and makes the point, he wins. Before picking up his winnings in stock, however, he must pay out enough real money to cover the option price. Then the U.S. Treasury expects to receive its portion of the winnings in real money—even while the law prohibits him as an insider from profiting on any sale of the stock for 12 months (6 months before and 6 months after the option is exercised). So the executive's free bet may turn into a bittersweet problem of cash flow management to finance the purchase price, holding cost, and tax payment on shares won. *Exhibit II* shows a typical sequence.

Probably the major impediment of stock options as an incentive is not the financing problem or even the special sensitivity to options shown by regulatory agencies and some investors. Rather, it is the market. The executive does a good job and the company prospers.[1] But the market price of the stock fails to rise accordingly. As is well known, this experience was common in 1974 and 1975. Conversely, the market often displays fits of euphoria for companies that never produce satisfactory earnings. Such manic-depressive tendencies may impair the market's judgment of a company's operating results,

1. For another view, see John C. Baker, "Are Corporate Executives Overpaid?" HBR July-August 1977, p. 51.

producing stock option rewards or nonrewards little related to executive accomplishment.

While passing the 1976 Tax Reform Act, Congress also directed the IRS to develop regulations for elective valuation of nonqualified options at the time of grant. The executive could choose either to treat the option as having no value until exercised (the former practice) or to place a value on the option itself within the year of the grant according to a valution formula. (At the time of writing, regulations covering elective valuation of options have not been issued.)

By electing valuation at the time of the grant, he establishes some—probably small—earned income, which is taxable to him and deductible by the company in the year of the grant. That valuation amount augments the person's basis for subsequent capital gain on sale of the stock. (The IRS has not yet made clear whether, if the option expires unexercised, the option value is treated as a capital loss or the executive is simply out of pocket the amount paid as tax on the option at grant.)

Elective valuation of a nonqualified option places his tax treatment and the company's cost close to that of a qualified option. Unless the terms of new nonqualified options prohibit elective valuation, the company is exposed to an unknown cost with every option grant.

# Other approaches

Stock options predominate among the long-term incentives for executives, but disappointments in the operation of stock options have stimulated other arrangements to provide a stake in company growth and profitability.

## Performance shares

Some companies have chosen to award stock bonuses with the executive's rights to the shares contingent on achievement of certain goals. These performance share plans have yet to be widely adopted, even though they offer attractive opportunities in plan design. The specified performance goals may be corporate, divisional, or individual job results, and the number of shares awarded may vary for achievement above or below goal. The plan thus directs the executive's attention to definite operating objectives as well as to stock price.

Because the company awards shares as a stock bonus, the executive faces none of the financing problems associated with buying and holding shares under an option plan. On receipt of the stock, however, he is taxed at the earned income rate for the current market value of the stock. Any subsequent appreciation in the price of the shares becomes a capital gain, taxable on sale of the stock. To help meet the initial income tax obligation, some companies couple a cash bonus with performance shares.

Because the company must disclose in its financial statements the compensation expense, performance share plans lack the low visibility of stock option plans. At the time the contingent award of shares is established, the company begins accruing its compensation liability by making an annual charge to the income statement at the year-end market value of the award. The company, however, may take a deduction for tax purposes when it issues the shares.

When it meets the contingencies of employment time and operating results and issues the stock, the company credits its capital surplus for any tax benefit excess over the tax benefits related to the earlier compensation expense. If the tax benefits, on issuance of the shares, prove to be less than those anticipated on the book compensation account, the difference may be treated as an income tax expense or as a charge to retained earnings.

A significant difference between performance shares and stock options lies in the value and volatility of what is granted to the executive. A stock option provides only an *opportunity* for gain; its value depends totally on market appreciation. Under a performance share plan, however, the stock bonus, if earned, has a definite initial value and any stock price change increases or reduces that value. Accordingly, to provide a given level of compensation for the executive, the company uses fewer shares under a performance share plan than with stock options. Even if satisfactory operating results are accompanied by a downturn in stock price, under a performance share plan the executive receives some reward.

Legal counsel often recommends that a company obtain stockholder approval for a performance share plan. Even though the SEC does not require such

**Exhibit III**
Features of long-term incentive plans

| | Nonqualified stock options | Performance shares | Stock appreciation rights | Participating units |
|---|---|---|---|---|
| **Definition** | Right to purchase shares in future at price set at time of option grant | Stock bonus, with right to shares contingent on achieving operating goals | Deferred cash bonus; promise to pay in future an amount determined by stock price | Deferred cash bonus; promise to pay in future an amount determined by operating results |
| **Incentive** | Long-term reward based on stock price increase | Long-term reward based on operating results and stock price<br>Number of shares awarded may vary with operating results | Long-term reward based on stock price increase (stock appreciation rights) or stock price (phantom stock)<br>May magnify or dampen payout in relation to stock price changes | Long-term reward based on operating results of company, subsidiary or unit<br>May magnify or dampen payout in relation to operating results |
| **Executive's tax** | At exercise: gain over option price taxed as earned income<br>At sale: gain over market price at exercise taxed as capital gain (plus preference item) | At issuance of shares: market value taxed as earned income<br>At sale: gain over price at issuance taxed as capital gain (plus preference item) | When paid: amount paid taxed as earned income | When paid: amount paid taxed as earned income |
| **Financial accounting** | No effect on income statement at grant or at exercise<br>At issuance of shares: credit capital stock for cash paid by executive; credit capital surplus for tax benefits on amount taxable to executive at exercise; increase number of shares outstanding | Accrue compensation liability annually; charge income statement per market value<br>At issuance of shares: credit capital surplus for any tax benefit excess, or charge tax expense or retained earnings for any tax benefit reduction; increase number of shares outstanding | Accrue compensation liability annually; charge income statement per value of units<br>Payment of units: no effect on income statement<br>Tax deduction on amount taxable to executive in year paid | Accrue compensation liability annually; charge income statement per value of units<br>Payment of units: no effect on income statement<br>Tax deduction on amount taxable to executive in year paid |
| **Other considerations** | Shareholder approval required<br>Stock must be registered<br>Insider trading rules apply<br>Executive must finance purchase and holding | Shareholder approval advisable<br>Stock must be registered<br>Insider trading rules apply<br>No financing required by executive | No shareholder approval needed<br>No stock registration<br>No securities rules apply<br>No financing required by participant | No shareholder approval needed<br>No stock registration<br>No securities rules apply<br>No financing required by executive |

approval, the agency does require mention of stock bonuses in the proxy statement. State regulations are sometimes vague on the question of stockholder approval for these plans. At any rate, a company can avoid possible challenge by getting stockholder approval for the performance share plan before issuing shares to participants.

Restricted stock, once widely used in executive compensation, declined in popularity after the 1969 tax law changes and is now a rarity. Recently, however, restricted stock has gained new interest. The company may treat dividends paid on restricted stock as a tax-deductible compensation expense, but the economics of restricted stock offer no special advantage over other compensation methods that are simpler and more flexible in both design and administration.

## Stock appreciation rights

Instead of granting a stock bonus or an option to buy stock, the employer can promise a future cash payment, the amount to be determined by the stock price increase. Under such stock appreciation rights, the amount payable per unit awarded equals the appreciation, if any, in the price of the stock from the time of award to the time of payment.

It is becoming fashionable to combine appreciation rights with options as a vehicle for generating the cash the executive needs to buy the optioned stock.

Careful drafting of the plan can ensure that the cash payment is used for this purpose. When offered a choice, however, many executives opt for all cash instead of shares. About one out of three large companies now has adopted stock appreciation rights plans, and half of those companies are integrated with options.

A close relative of stock appreciation rights is "phantom" stock. A plan using this device awards units, each with the full value of a share of stock. When time and any other requirements are satisfied, the company pays the person for his vested units at the current price of its stock, regardless of whether the amount is above or below the price when the units were awarded.

The executive's income tax treatment under a stock appreciation rights or phantom stock plan is like that for any other cash compensation: the tax is payable for the year in which the award is paid, at the earned income rate. In all deferred compensation plans, care in drafting the plan will protect the executive from being taxed prematurely for constructive receipt.

Accounting for this form of compensation requires the company to accrue the compensation liability over the period of related service, with a charge to income according to the value of the stock appreciation rights or phantom stock units at year end. Because of the prior accrual, on payment of the units the income statement will show no additional charge. The company takes its tax deduction on the amount taxable to the executive in the year in which the payment is made.

In spite of the names given these plans and their orientation to market price, stock appreciation rights and phantom stock plans should be considered deferred cash bonuses. The company issues no shares, it need not obtain shareholder approval for the plan, and no securities trading rules apply.

Although few companies have yet availed themselves of the opportunity, either stock appreciation rights or phantom stock plans can be designed to depart from a direct relationship to the price of the stock. The payout formula may magnify, dampen, or limit the executive's payment in relation to market price changes. Consider these devices:

□
To excite interest in the plan, a company whose stock price is lethargic may multiply the payout in relation to price changes.

□
Conversely, to limit its cost and the risk to its executives, a company whose stock price is subject to wide swings may use a declining payout formula or set a maximum payout.

Such flexibility in plan design is a distinct advantage of cash payment plans such as stock appreciation rights, phantom stock, and the final form, participating units.

## Participating units

This device (often called performance units and thereby confusing it with performance shares) involves the executive directly in the company's growth and profitability. As with stock appreciation rights, the company promises to pay according to a formula; but in this case operating results rather than stock price determine the payment.

The company may choose to reward the participant according to pretax income, return on investment, sales and backlog, or a combination measure of results. The design of the payout formula is flexible, permitting provision for payments limited, reduced, or multiplied in relation to operating results. For example, one manufacturer provides a progressively greater gain in unit value for each 1% increase in EPS over the prior two-year average EPS.

The payout formula may be based on a gain in operating results so that, for example, only an increase in EPS during the deferral period creates value in the participating units. This incremental-value-only approach offers the kind of risk to the participants that stock options have—that is, no increase means no payout. Companies that have adopted participating units plans, however, have generally chosen the initial-value-plus formula, with units awarded at $1 and increasing or decreasing in value as operating results change. This less risky approach is more acceptable when the units are regarded as deferring part of an annual incentive award.

The participating units plan is distinguished from all the stock-related plans by rewarding solely and directly for operating results. It fits a closely held corporation, a subsidiary, division, or any organizational unit whether or not stock is available. A hotel-operating subsidiary of a transportation company, for example, adopted a participating units plan to reward its executives solely for the operating results of the hotel business. A Japanese electronics corporation uses such a plan as an incentive for managers of its U.S. subsidiary; the parent company's stock is neither available nor relevant.

The tax treatment of participating units is identical to that of stock appreciation rights, payments being taxable as earned income when paid to the executive. The company accrues a compensation liability annually, charging to the income statement the value of the units as of year-end. Payment of units produces no additional effect on the income statement, but does permit the company to take its tax deduction on the amount taxable to the participant in the year of payment. No shareholder approval is needed to establish a deferred cash bonus in the form of participating units. And, of course, no securities rules apply.

Of the choices available, participating units have the fewest features in common with qualified options. Yet participating units come closer than any other type of plan to the rationale on which qualified options were usually based: reward tied to long-term growth and prosperity of the organization.

Free from the vagaries of stock market prices, participating units permit an organization to design its long-term incentive plan to provide the reward it intends for the results it wants. That advantage, however, coincides with a problem: someone must decide in advance what operating results and what payouts are suitable. That kind of planning and commitment may be difficult to get, whereas a stock-based plan conveniently shifts much of the responsibility to that impersonal arbiter of corporate worth, the stock market. The gods that dwell in Wall Street decide the payout.

While the participating units approach calls for a higher order of responsibility in operations budgeting and rewards planning, it also ensures greater cost control. By design, the amount paid out for participating units remains related to the organization's ability to pay. Units increase in value only as the organization increases its earnings; and if profits decline, so does the payout obligation. The only stock-based plans certain to work this way are those using company book value as the measure of reward.

## Money's worth

It is safe to predict that in making long-term incentive arrangements for executives, some companies will simply follow current fads, and today's trend is to couple nonqualified stock options with stock appreciation rights. The demise of qualified options, however, invites closer attention to new approaches, and an increasing number of companies will review their plans against an assessment of the organization's needs. Where no one plan seems to fit, multiple or combination plans may help accomplish the company's motivation and cost aims. *Exhibit III* summarizes plans in use.

Although financial accounting differs among plans, no plan or combination of plans can provide the economic magic that qualified stock options once seemed to offer. Instead of looking for a free lunch, therefore, thoughtful employers today concentrate on getting their money's worth from all elements in the executive pay package.

Fundamentally, this means providing a sense of fair treatment. That may come less from plan design than from administrative decisions governing the criteria for eligibility and the size and frequency of award grants. Even a plan imperfectly designed, but administered impartially and with a results orientation, can satisfy those executives whose continued contributions are vital to the organization's well-being.