Some Stock Option Substitutes

Organizational
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Primer: Performance Shares

Key Provisions

- Grants of contingent shares of stock at beginning of performance period (us. 3 to 5 years)
- To the extent the targets are met, the shares may be paid in cash and/or stock
- Executive earns portion or multiple of shares originally granted
- If the minimum performance threshold is not met, the shares are forfeited

<u>Advantages</u>

- No executive investment required
- No dilution of outstanding shares unless paid in stock
- Performance oriented
- Executive's tax liability can be paid from award
- May help finance options
- Company receives tax deduction

<u>Disadvantages</u>

- Creates charge to earnings
- Can be difficult to set performance targets

Tax Impact

<u>On Executive</u>

- At grant: no tax
- At payment: payout taxed as ordinary income

<u>On Company</u>

- At grant: no tax deduction
- At payment: company receives tax deduction equal to executive's ordinary income

Earnings Impact

- Value of performance shares is charged to earnings each quarter and must be marked to market

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Performance Shares in Action

Timing **1--Years--5**

<u>Performance Share</u>	**<u>Grant</u>**			**<u>End of Performance Period</u>**	
Share Value	$5	Have Targets Been Met?	Yes →	$10	Paid in Cash or Stock
			No →	$0	Shares Lapse
Executive Investment	$0 →			$0	
Executive Gain	$0 →			$10.00	(Ordinary Income)
Executive Tax*	$0 →			$3.85 ($10 X .385)	Tax Due
Executive Net Gain (after tax)	$0 →			$6.15	Net Gain

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* This assumes the executive is subject to an ordinary income rate of 38.5%.

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Primer: Performance Units

Key Provisions

- Grants of units with absolute dollar value (e.g., $10), with payout contingent upon meeting stated performance targets over a specified period (us. 3 to 5 years)
- To the extent the targets are met, the dollar value of the units is payable in cash and/or stock
- If the minimum performance threshold is not met, the units are forfeited
- Frequently used as a financing mechanism for equity plans

<u>Advantages</u>

- No executive investment required
- Useful when stock price is stagnant
- Company receives tax deduction
- Potential max. charge to earnings fixed at grant
- Executive's tax liability can be paid from award
- Performance-oriented
- No dilution of outstanding shares unless paid in stock

<u>Disadvantages</u>

- Creates charge to earnings
- Can be difficult to set performance targets

Tax Impact

<u>On Executive</u>

- At grant: no tax
- At payment: payout taxed as ordinary income

<u>On Company</u>

- At grant: no tax deduction
- At payment: company receives tax deduction equal to executive's ordinary income

Earnings Impact

- Value of performance units is charged to earnings to the degree goals are achieved over the performance period

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Performance Units in Action

Timing **1--Years--5**

Performance Unit	**Grant**			**End of Performance Period**	
Unit Value	$30	Have Targets Been Met?	Yes →	$30	Paid in Cash or Stock
			No →	$0	Units Lapse
Executive Investment	$0	→		$0	
Executive Gain	$0	→		$30	(Ordinary Income)
Executive Tax*	$0	→		$11.55 ($30 X .385)	Tax Due
Executive Net Gain (after tax)	$0	→		$18.45	Net Gain

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Primer: Phantom Stock

Key Provisions

- Executive receives appreciation in book value, fair market value, or formula value of a specified number of shares
- Payable in stock or cash
- Executive may also receive dividend equivalents

Advantages

- No executive investment required
- Aligns executive interests with shareholders
- If paid in cash, does not dilute stock ownership
- Corporation gets tax deduction
- If value increases, can be retentive

Disadvantages

- Unpredictable charge to earnings
- Does not lead to direct stock ownership unless paid in stock
- Unless paid in stock, no direct stock ownership
- Less flexible, since valuation date set in advance

Tax Impact

On Executive

- At grant: no tax
- At payment: appreciation taxed as ordinary income

On Company

- At grant: no tax deduction
- At payment: appreciation taxed as ordinary income

Earnings Impact

- Appreciation is charged to earnings each quarter
- If paid in stock, dilutes EPS by increasing shares outstanding

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Phantom Stock in Action

Timing **1--Years--5**

Phantom Stock	**Grant**		**Payout**	
Fair Market Value (Book Value or Formula Value)	$30	→	$80	
Executive Investment	$0	→	$0	
Executive Gain	$0	→	$50	(Ordinary Income)
Executive Tax*	$0	→	$19.25 ($50 X .385)	Tax Due
Executive Net Gain (after tax)	$0	→	$30.75	Net Gain

* This assumes the executive is subject to an ordinary income rate of 38.5%.

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Primer: Restricted Stock

Key Provisions

- Outright grant of shares, with restrictions as to sale, transfer, and pledge
- Restrictions lapse over a specified period (e.g., 3 to 5 years)
- As restrictions lapse, the holder has unrestricted shares which he or she may sell, transfer, or pledge
- If the executive terminates employment, all unvested shares are forfeited
- During restriction period, the executive may receive dividends and can vote shares

Advantages

- No executive investment required
- Promotes immediate stock ownership
- Charge to earnings is fixed at grant
- If stock appreciates, company's tax deduction exceeds fixed charge to earnings
- Aligns executive's interest with that of shareholders
- Recognizable to most executives
- Offers potential long-term appreciation as company grows

Disadvantages

- Creates charge to earnings
- Executive may incur tax before shares sold
- Immediate dilution of EPS
- If stock depreciated, company's fixed earnings charge exceeds tax deduction

Tax Impact

On Executive*

- At grant: no tax
- As restrictions lapse, the current market value of vested shares is taxed as ordinary income
- Dividends received during the restriction period are taxed as ordinary income

On Company

- At grant: no tax deduction
- As restrictions lapse: company receives tax deduction equal to executive's ordinary income
- At sale: no tax deduction
- Dividends paid during restriction period are deductible when paid

Earnings Impact

- Fair market value at grant charged to earnings over restriction period
- Subsequent appreciation not charged to earnings
- Immediate dilution of EPS for total shares granted

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* Assumes no 83(b) election made by executive. If 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.

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Restricted Stock in Action

Timing	**1--Years--5**			
Restricted Stock	**Grant**		**Restrictions Lapse**	
Fair Market Value	$5	→	$10	
Dividends	$0	→	$1.00	
Executive Investment	$0	→	$0	
Executive Gain	$0	→	$11.00	(Ordinary Income)
Executive Tax*	$0	→	$4.24 ($11.00 X .385)	Tax Due
Executive Net Gain (after tax)	$0	→	$6.76	Net Gain

* This assumes the executive is subject to an ordinary income rate of 38.5%. If an 83(b) election was made within 30 days of the award, the executive would be taxed on the fair value of the grant as ordinary income, with subsequent appreciation treated as a capital gain.

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Primer: Stock Appreciation Rights

Key Provisions

- Commonly granted in tandem with options, where executive instead receive payment equal to excess of stock's market value at exercise over option price (but see below)
- May be
    - attached to *incentive stock option* or *non-qualified stock option* or
    - granted on stand alone basis without existence of an option
- Payment may be in cash, stock, or a combination

Advantages

- Executive forced to think like shareholder
- Avoids executive financing costs of options
- Gains may be capped by company

Disadvantages

- Stock prices changes may not parallel executive performance
- Accounting expenses are unknown at start

Tax Impact

On Executive

- Value between fair market value at time of exercise and price indicated on SAR is taxable income in year of exercise and subject to withholding

On Company

- Tax deduction in amount of executive's income from exercise is allowed in year executive is taxed

Earnings Impact

- Value of right (i.e., excess of market value of stock over option price at close of each accounting period) is compensation expense that is accrued over the period SAR is outstanding

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Stock Appreciation Rights in Action

Timing	**1---Years---5**			
Stock Appreciation Rt.	**Grant**		**Exercise**	
Fair Market Value (Book value or formula value)	$30	→	$80	
Executive Investment	$0	→	$0	
Executive Gain	$0	→	$50.00	(Ordinary Income)
Executive Tax*	$0	→	$19.25 ($50.00 X .385)	Tax Due
Executive Net Gain (after tax)	$0	→	$30.75	Net Gain

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* This assumes the executive is subject to an ordinary income rate of 38.5%.

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