7-1973

Comparative Analysis of Five Stock Plans

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COMPARATIVE ANALYSIS OF FIVE STOCK PLANS

by
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University of Maryland, 1965

An Independent Study
Submitted to the Faculty
of the
University of North Dakota
in Partial Fulfillment of the Requirements
for the Degree of
Master of Business Administration

Minot Air Force Base, North Dakota
July 1973

This Independent Study submitted by Charles King Markline in partial fulfillment of the requirements for the Degree of Master of Business Administration from the University of North Dakota is hereby approved by the Faculty Advisor under whom the work has been done.

Advisor

PERMISSION

Title: Comparative Analysis of Five Stock Plans

Department: School of Business and Public Administration

Degree: Master of Business Administration

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CHAPTER I

INTRODUCTION

Managerial positions are those which encompass such functions as planning, directing, controlling, appraising, and supervising work or people or both. Although the specific duties of these positions as well as their level of responsibility vary, they are all performed within the managerial hierarchy.

These positions have not always had the careful analysis and problem-solving salary procedures applied to them or have not always been given the same degree of attention as early as nonmanagerial jobs. Job evaluation techniques were first applied to nonsupervisory in most organizations and, in some, are still only applied there. Incentive pay applicability to upper level jobs is still being argued in some circles. The income tax burden of executives has not always been properly in focus in considering ways and means of improving income retention potentials. Fortunately, an even increasing number of organizations today are seeking methods for solving the problems of rate structures and levels, financial motivation, and income retention more than ever before.[1]

Incentive pay plans for managerial employees currently are receiving more than the normal amount of attention from corporate top management. Three primary reasons account for the present interest: (1) the search for new devices to stimulate improvements in corporate

[1]Elizabeth Lanham, Administration of Wages and Salaries (New York: Harper and Row, 1963), p. 421.

profit performance, (2) the need to evaluate the value and effectiveness of plans and the expense they represent because of increasing costs and skrinking profits, and (3) the effect of plans on differentials between total compensation of managers and their subordinates which have narrowed in recent years.

The purpose of this paper is to compare and contrast five basic stock plans used in executive compensation. The five basic stock plans are: (1) phantom stock; (2) stock option; (3) stock warrant; (4) stock bonus; and, (5) stock purchase. For ease of presentation, the discussion of the stock option and warrant is incorporated into one area because of their close similarities. The paper itself is divided into three sections, the introduction, the plans, and summary and conclusions.

The introductory section will state the purpose of the paper and briefly outline what is to be covered in the remainder of this endeavor. The main body of this paper goes into detail regarding the four main topics to be covered. In this section each of the stock plans will be examined regarding what each is and how they are used. Also, in this section, an attempt is made to point out the advantages and disadvantages of each. It is not the purpose of this paper to determine which of these is the "best," so each one will be presented on it's own merits. In the summary and conclusions section each of the four main plans is highlighted and by use of two exhibits an attempt is made to show in what categories and to what degree these plans may differ.

CHAPTER II

THE ANALYSIS OF THE STOCK PLANS

Phantom Stock

A phantom stock plan gives some of the advantages of stock ownership to an executive but does not transfer any stock to him. A record is made of the phantom shares credited to the participant. He then receives dividends as any bona fide stockholders do.

Basically, phantom stock enables executives to profit from company shares that they do not own--shares, in fact, that may not even exist. The profit may be in one of several forms. In the simplest, the executive is awarded units of a certain number of imaginary shares of company stock and receives every year a sum equal to the dividends on these shares. The payments are usually accumulated in the executive's account until he retires, although several companies pay out cash every year. In variations on this theme, in addition to the dividend equivalents, the executive may also be given the market appreciation of the non-existent shares over the years on the actual shares on a deferred basis.

Thus, while the market flucuation of the company's stock can affect the executive's overall compensation, he is assured of a payoff year after year as long as the company keeps paying dividends. Companies that give phantom stock to executives strive to keep those dividends coming; most, indeed, have succeeded in increasing them considerably over the years.

Phantom stock plans, though little publicized, are not really new. They have been around for over fifteen years, and among the long-time users are DuPont, General Motors, Union Carbide, Koppers, Bethlehem Steel, and Eastman Kodak.

Under present conditions, phantom stock may be the most practical compensation gimmick around. Stock options, for example, while still far from dead lost a good deal of their appeal with the tax changes of 1969, and a lot more in the market. Moreover, stockholders tend to be highly critical about stock option awards, not to mention those six figure executive salaries and bonuses, particularly when they are already unhappy over market losses and falling earnings. But they are less likely to complain about compensation based on dividends--a benefit they also receive and would themselves like to see get bigger every year.

What is really interesting about phantom stock awards is their cumulative effect. Not only does the executive collect the dividends on his units every time the company makes a payout, he can be awarded new units year after year. As units are added to units, and dividend payouts to dividend payouts, the executive's account can build up spectacularly.

The real advantage of phantom plans for the executive is that he is not required to risk a cent of his own money and so never has to worry about financing. Even in the plans that include stock, it is never the executive's own cash that is risked; the company provides the stock. Compare this to the plight of the executive with stock options caught in the tight money-bear market syndrome.

There are other benefits as well. Not the least of these is the familiar realm of taxes. For the company, phantom distributions, unlike those made under qualified stock option plans, are tax deductible when the money is paid out. For the recipient, as with any other type of deferred compensation, he pays no tax until after he is retired, when his income will almost certainly be lower. He then has to pay regular income tax and not the capital gains rate of the qualified stock option. The 1969 Tax Reforms have made the capital gains benefit less attractive for many top executives. Moreover, having that tax money working for him during all the years before retirement, is a marked advantage.

Taking a closer look at the types of phantom stock plans, there are four major variations. The simplest is the straight dividend equivalent plan. EXAMPLE: Say a man has a bonus award of $15,000 coming to him. He decides he will take $5,000 in cash and have the rest deferred. An account is set up for him in units equal to the number of shares $10,000 would buy. From then on, whenever the company declares a dividend, he collects the equivalent amount on each of those units. And it is all added to his account, to be paid out after he retires.

In the second type of plan, the executive can do even better. Along with his dividend equivalents, he gets the market appreciation, if any, that would have been his had he owned actual rather than phantom shares over the years. (The underlying value of the shares themselves reverts to the company when he leaves). Take an executive who at the year end is credited with 500 phantom shares at $20 each. If the market price of the stock rises to $50 by the time he retires or departs, his appreciation comes to $30 on each of those phantom shares--plus, of course, a smaller amount on any phantom shares granted him later when the stock was at, say, $25, or $45. But he gets no appreciation at all on any shares awarded him when the market price was above the price at the time he leaves ($50).

In the third variant, the executive eventually gets to own some actual shares. For with his dividends equivalents, he is granted deferred stock. Again, the shares may not physically exist during his years with the company. But when he retires, the company provides them, and he goes into retirement with the whole package--accumulated dividends plus stock. Obviously, the market's ups and downs will determine the worth of the shares.

The fourth phantom type differs only slightly. Here the executive again benefits over the years from company stock he does not own, and eventually gets title to an equivalent number of shares. But the dividend equivalents, instead of being deferred, are given to him each year in cash. Consequently, they constitute ordinary income to him in the year in which they are paid, and are thus subject to full tax at that time.

Unlike stock obtained with options, performance shares (phantom stock) cost the executive nothing, making them a benefit in good markets and bad. They are awarded to key executives, usually every other year, in the form of phantom shares in bookkeeping units, but are not actually paid until the end of a performance period.

But performance shares may never be paid at all. This would happen if the executive fails to measure up in his own performance or if he leaves the company. It would also happen if the company's performance, usually measured in earnings per share, does not meet predetermined goals. The performance share is thus a kind of stock bonus, but with the reward based on long term goals instead of a one year objective.[1]

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[1]"Performance Shares: Popular - but Under Fire," Business Week, May 5, 1973.

Stock Options

A stock option granted by a corporation to one of its executives stipulates that he may purchase from the firm, at any time within a stated period, a given number of shares of its stock at a price fixed on the date of granting.[1] Since the economic benefit the executive ultimately derives from such an arrangement depends directly on the future price behavior of his company's stock, the option has associated a high degree of uncertainty and is, for that reason, particularly difficult to analyze.

Stock options have, in one form or another, been used to reward executives for a good many years. Their real popularity, however, dates from 1950 when legislation was enacted providing them with favorable and assured tax treatment and establishing definite ground rules for their design. Since then, virtually all option agreements have conformed to those guidelines.

Prior to 1950, a 1945 decision of the U.S. Supreme Court and a 1946 ruling of the Bureau of Internal Revenue required that the difference between the market value of stock and its option price be considered as ordinary income taxable at regular rates at the time the employee exercised his option rights.

A 1950 revision in the Internal Revenue Act resulted in widespread adoption of restricted stock option plans. The change in the law created one of the best possibilities for tax saving on executive compensation.

The 1950 rule states that if a company offers its employees an option to buy stock at not less than 85% of market value at the time of purchase, profit from the stock is not taxed until the stock is sold

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[1] Wilbur G. Lewellen, Executive Compensation in Large Industrial Corporations (New York: Columbia University Press, 1968), p. 46.

and the profit received. The profit is taxed then at regular income tax rates. If the organization offers its stock to employees at not less than 95% of market value, any profit from the stock is not taxed until the stock is sold. The profit is taxed at that time as long term capital gains rather than at regular income tax rates.

Additional requirements under the law for qualifying for the tax benefit are: (1) the stock must be held at least two years from the time the option is offered and for a minimum of six months after the option is exercised; (2) eligibility to participate depends on the issuing company and taking up his option during his employment or not later than three months after termination of his employment; (3) the option right cannot be transferred except by will or interstate succession laws; (4) any employee is ineligible who owns more than 10% of the combined voting power of all classes of stock of the issuing company or its subsidiaries.

Common stock is generally the class of stock offered in option plans because its earnings are closely linked to the prosperity of the company. Therefore, ownership of common stock, bought on favorable terms, often serves to stimulate greater efforts on the company's behalf.

Participation in the plan is usually limited to the top echelon of management. These executives ordinarily are in a better position to contribute to the profit a company can make, they are in a high enough tax bracket that real tax savings can ensue, and they are most apt to be able to afford to exercise the option. Typical bases used for selecting the individual participants are: (1) present and potential value to the organization; (2) responsibility for future growth, development, and financial success of the company; and, (3) the position held and its value to the company.

The number of shares offered to a participant may be based upon the amount of his base salary, his performance, or by special agreement or contract with him

Within the general framework indicated, an option plan could be designed quite flexibly to fit the needs of both the individual executive and his firm. In most cases the maximum period permitted under the law was taken advantage of and the option stipulated to be exercisable, at the optionee's discretion, at any time up to ten years from the date it was granted, either in a single block or in several installments. Depending on the corporation's objectives, a shorter time limit was occasionally adopted, and provision was sometimes made for a fixed sequence of exercises. For example, one-tenth of the total number of optioned shares might be eligible for purchase by the executive during the first year of the agreement, a second one-tenth during the following year, and so on.

The essence of a stock option is, of course, the opportunity it provides for its recipient to purchase marketable securities at a discount. He is placed in a position where he can do something other investors cannot and is thereby able to employ his investible funds in a superior manner. There are, however, two possible conceptual approaches to measuring the extent of the advantage which he enjoys.

The first is to treat the option as, in effect, a long term "call" option and therefore to fix its value to the executive as of the date it is granted. The argument would be that the right to purchase shares of stock at an established price anytime within a period of up to ten years is clearly worth something in and of itself at the time it is created regardless of the actual results subsequently obtained from its exercise.

The second point concerns the applicability of such a procedure to an actual compensation situation--an issue which has been stressed in connection with the current income equivalents of other rewards. Given the difficulties involved in estimating future stock prices, it seems unlikely that any predictive formula adopted here would be widely used by businessmen or, even where accepted, that its parameters could be agreed upon in practice by both parties to particular compensation transactions. Thus, one can imagine the difficulty that would be encountered by a corporate compensation administrator in attempting to reach agreement with his company's executives on the ex ante value of their proposed stock options. Now, it is true that the current equivalents developed above for pension and deferred compensation arrangements have some ex ante elements. It is also true that the relevant contingencies have been analyzed so extensively with the aid of large amounts of data that the necessary conceptual framework and its empirical implementation are no longer subjects of controversy. Whenever an appraisal of such contingencies is called for, then, it can be made with both confidence and precision. A similar claim is not yet possible for ex ante stock price estimates.

Stock warrants will now be discussed briefly because of their close similarity to stock options. The stock warrant plan is one in which an organization sells a warrant to an executive granting him the right to buy a specified number of shares of stock at a certain price within a definite period of time. The warrant is a negotiable instrument. Therefore, the holder may sell it if he desires when the value of the stock increases over the price offered in the warrant and secure a profit which is taxed as capital gain and not as ordinary income.

Stock warrant plans are offered as a substitute for regular stock option plans in some organizations because some executives cannot afford financially to exercise their option. Under the warrant plan, the executive may exercise his option to buy stock or sell his right to the option. If he does the former, the plan is the same as the stock option plan. If he follows the latter course, he has not had to finance a stock purchase but still has received some extra compensation at a lower tax rate than if he had been given more cash salary. On the other hand, he has not become a proprietor with its attendant advantages. Despite this disadvantage, the stock warrant plan may fit the financial needs of executives in a particular firm better than the pure stock option and be the preferable method of the two.

Today one of the advantages of including stock options in the compensation package of some key executives is the mere fact that many companies do it. While this sounds, at first, like simple "metooism" it is not. Essentially, it is a part of the general corporate policy of providing compensation that is "at least comparable to that being paid for similar positions in other firms in our industry." Thus, the ability and even the willingness of the corporation to offer a stock option to executives who desire or demand one, in itself, provides an advantage to the company.

The second well recognized advantage that companies see in the option plan is that it is one of the few compensation devices that tends to be associated with the individual executive as a person. Salary, for example, is generally hemmed in by the position level and seniority as well as the concept of internal compensation equity. Bonuses, which started on an individual performance basis, have gradually become institutionalized by class of employee or have been related to the profit center concept. The stock option, on the other hand, has more of the personal meaning of an executive contract. It has the status, in most firms, of acceptance into an exclusive club.

A third advantage, and one occuring in a number of firms during the last two decades, is simply the possibility of making a highly valued executive rich. The stock option is a device that in many beginning companies has been used in lieu of the old "share the profits" concept financial reward to the risk taking executive. Both devices have been used by directors to encourage entrepreneurial behavior by top company executives.

A fourth major advantage is the common assumption by compensation planners that restrictions placed on the exercise of options, e.g., purchase of 20% each year over five years from date of grant, induce executives to stay with the company. Of course, the practice of granting stock options serially can compound this effect over many years of a man's career.

Another advantage cited by executives is the variety of purposes served by options as a form of compensation. For example, in a single firm, stock options may be awarded from one plan to meet various needs, such as an outsized option being included in a new chief executive's contract to motivate him to turn the company's fortunes around.

Before leaving the discussion of stock options, the effects of the Tax Reform Act of 1969 should briefly be touched upon. Prior to this it was widely accepted that the stock option was by far the most popular method of executive compensation.

The tax law affects options in several important ways. Corporations have been allowed to grant stock options since 1951, and now more than 90% of the largest U.S. industrial companies have some form of "qualified plan." In order to "qualify" for favorable IRS capital gains treatment, an option must be issued at 100% of market value, be exercised within five years, and held for three years before sale. Under the old law, an executive paid no tax until he sold his stock, then paid a capital gains tax of no more than 25% on the difference between his option price and his selling price.

Beginning in 1972, the old rate will go up to a 35% maximum for all capital gains of more than $50,000. But what really takes the most out of the qualified option is a brand new provision. Now, in the year he exercises a qualified option, an executive must report the paper gain between the option price and market price as tax preference income, even though he still has to wait three to sell it for capital gains.

The figures begin to hurt when they get big enough to reduce the "earned income" sheltered by the new 50% maximum tax, thus shoving more of that income into the ordinary 70% tax bracket. The net effect is that the higher the paper gain from exercising stock options, the bigger the tax bill on salary and bonuses.

Stock Bonus

Stock bonus plans are those which provide for the giving of the shares of stock to an executive as part of his total compensation. This not a tax saving plan, however, since the recipient must pay tax on the market value of the stock in the year of receipt. It's major advantage is that the executive is given a share in the business which may accomplish certain of the objectives of stock option plans.

The stock bonuses employed by corporations come in several forms, which in each instance they consist of awards made to the executives in shares of his company's stock, the timing and duration of the payments involved may vary considerably. The variant which is easiest to handle is that in which, like a straight cash bonus there is but a single payment occuring at the end of the year during which the services that gave rise to the bonus were performed. Such a payment is taxed to the executive as ordinary income and valued for that purpose by the Internal Revenue Service at the market price of the shares on the date they are transferred. This type of bonus may be treated just as a cash award would be. It is worth in after-tax terms the gross market value of the stock received minus the applicable tax liability and its "after tax current equivalent" is simply that same amount.

A second common arrangement is also very much like a form of cash bonus. In it, payments are spread over a period of several years immediately following the award year rather than being made in a single lump sum. A series of four or five equal annual installments is the most frequent choice. In this case again, the installments are taxed as ordinary income at their market value when received, and therefore their after-tax current equivalent will be defined as the corresponding series of net additions to salary. The only difference between this device and that in which the bonus is in the form of cash is that the final value of the award is not fixed at the time it is made but instead depends in part on stock price developments during the next few years. This means that it is necessary to record the price of the firm's stock on four or five separate dates rather than on just one in order to construct the desired current equivalent. This is a simple task, however, and merely implies that the appropriate alternative to this kind of stock bonus is conceived to be a series of salary increments which themselves are a function of the firm's stock price over time. There is nothing conceptually incorrect or even inconvenient in such an arrangement.

The third variety of stock bonus is really just another form of deferred compensation. Rather than a given amount of cash being set aside for payment to the executive following his retirement, a given number of shares of stock are so allocated. Thus, the executive may stand to receive a series of stock allotments beginning at age 65, continuing for a specified number of years, and taxable at ordinary income rates. If he should die before attaining retirement age or thereafter before receiving his bonus in full, his estate is entitled to the remaining shares. As is evident, the difference again between such a promise and a cash payment contract is the dependence of the value of the ultimate receipt on interim stock price movements. However, since the objective is to derive a current income equivalent which applies as all previous ones have, only to the executive's active working life, it is not possible to wait until the time of each scheduled receipt of stock before fixing the amount of that equivalent. An alternative must be designed which, as in the case of a stock option, anticipates the final outcome. The approach that is suggested here defines the after tax current equivalent of a deferred stock bonus to be a series of annual salary increments which: (1) begin in the year the bonus is awarded; (2) continue to the executive's normal retirement age; (3) have the same prospective after tax present value as that estimated for the deferred bonus payments; (4) are revised each year in response to any change in this estimate.

For example, suppose that, in 1950 an executive age 50 is promised a deferred stock bonus of 1,000 shares per year in each of the first five years following his retirement at age 65. At the time of this promise the market price of his firm's stock is $25 per share. The initial estimate of the ultimate value of his bonus is therefore $25,000 per year, before taxes, for five years. Given the size of the man's salary in 1950 some "outside income" may be projected for him in retirement. With that figure and an estimate of deductions and exceptions, the after tax value of the five bonus payments can be determined, as in the case of a conventional deferred compensation arrangement. The present value of this expectation as of 1950 is then calculated, and the first stage of the after tax equivalent specified to be simply that series of fifteen equal annual additions to after tax salary which, if received from 1950 through 1964, would have the same present value. The amount of the current equivalent for the year 1950 is, accordingly, the first payment in the series. Suppose further that, in 1951, the stock rises in price to $30 per share. Our estimate of the worth of the deferred bonus is now revised upward by $5,000 per year, the additional after tax present value implied by that revision computed, and a second stream of fourteen payments established having a present value equal to the increment. The current equivalent for 1951 is then the sum of this new figure plus the one from the 1950 calculations. The process is repeated every year up to and including age 65, the results being a current equivalent consisting once again of a number of overlapping "layers" and covering the full time period from the date of the bonus arrangement is instituted up to the executive's retirement. By this latter date, the executive will have been credited with extra income over the years equal in value to that dollar amount which, after taxes, his bonus now promises him. He, therefore, will have been made as well off, which is the test here of equivalence. The effect, then, is to consider the deferred stock bonus to be simply a deferred compensation contract which happens to require not just one but a series of appraisals in order to be analyzed completely.

Stock Purchase

Stock purchase plans offers the executive an opportunity to buy company stock at a fixed price. If the executive accepts, he commits himself to buy a definite number of shares at the price offered. Many organizations help the executive finance his purchases by permitting him to pay for the stock over a period of time, advancing funds to him which are repayable through payroll deductions, and lending him the money outright at low interest rates. A number of plans offer the stock at a "special price" (lower than market) and some include an agreement that the company will buy back the stock at the price the executive paid even though its value has declined.

The primary purpose of stock purchase plans is to encourage ownership in the company which, hopefully, will stimulate better performance and continuity of employment. However, stock purchase plans have been superceded since 1950 in many organizations by the stock option plan.

While there is considerable disagreement as to the relative merits of employee stock ownership programs, proponents can point to a number of practical corporate uses for such plans, among them being their use:

1. As an incentive to increased employee interest in, participation in, identification with, or loyalty to a company.

2. As a means of transferring ownership to succeeding employee generations or providing business continuation, particularly in close held corporations

3. As a method to raise capital, without resorting to outside sources or control or to create an internal market for company stock.

4. As a device in certain types of plans for maintaining internal control of a company.[1]

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[1]James B. Zischke, "New Developments in Employee Profit Sharing. Stock Purchase, and Time Plans," Employee Bonds and Pension Management (November 1964), pp. 30-32.

There are various routes open for the development of employee stock purchase programs. Of these, the most advantageous for purposes of any broadly based plan is usually the qualified Section 401(2) plan. This route, normally utilizing the profit sharing vehicle (but sometimes organized technically as a "pension" or "stock bonus" plan for qualification purposes), offers a number of special advantages, particularly from the tax standpoint. It is the only stock purchase arrangement which can work entirely with before tax earnings dollars of both the employee and the corporation. It is an arrangement, once established, which can be continued automatically in the future. And of considerable import to the employees, special tax treatment accorded distributions from Section 401 (2) stock purchase plans can, in effect, permit "employee owners" to pass on their share of any appreciation in the value of a business on either an income tax free or estate tax free basis.

Besides this, several other methods of employee stock purchase, utilizing the option approach, have to some extent been clarified by the Internal Revenue Code Amendments of 1964. The first of these is the qualified stock option plan (Section 422 plan); this is a successor to the former restricted stock option. While there is little question that the rules of the new Section 422 destroy much of the value of stock options as a compensation device, they are not nearly so onerous where the objective is to provide a device whereby selected employees can acquire a proprietary stock interest in the business.

A second option route laid out by the 1964 Act is the so called employee stock purchase plan (Section 423 plan). This particular addition to the field of employee stock purchase is of highly questionable value from the corporate standpoint, except perhaps in very specialized situations. Not only does this largely new section of the code introduce considerable confusion into the terminology of employee stock purchase plans (by usurping the name "employee stock purchase plan" for an arrangement which is really an option plan and furthermore representative, at best, of a small proportion of employee stock purchase arrangements) but it also creates what may be a dangerous precedent by introducing for the first time into the legal framework of corporate employee benefit plans the concept that a plan, in order to be viewed favorably, must cover generally all full time employees.

In the area of direct purchase programs, that is, those plans which provide systems whereby stock or purchase arrangements are made available to employees for acquisition of shares on a direct basis, a recent innovation of certain of the stock brokerage houses appears to offer considerable potential for those corporations with a traded stock which wish to set up relatively simple plans for employee stock purchase. Under these systems, an employee subscribes through payroll deduction; block purchases of stock are made by the broker; and share interests are broken down by the broker into individual investment accounts for each employee. The employee may continue to accumulate his account with the broker, or at any time take any of the actions (such as sale, request for issuance of certificates in his name, and so on) that any other person maintaining an account with the broker might do. The primary advantages of the system are simplicity, freedom to the corporation from any administrative or record keeping details other than payroll deduction, and considerable savings to the employee in investment costs over those which he would normally incur in small lot purchases. There is also little cost to the corporation in establishing such a program, other than a nominal service charge which may be made by the broker for record keeping activities.

CHAPTER III

SUMMARY AND CONCLUSIONS

This paper has examined five basic plans. Emphasis has been placed on what each of the plans are and how they are used. Additionally, an attempt has been made to point out the advantages and disadvantages of each, both to the employee and the employer. In the course of the discussion no attempt has been made to determine which of the plans is the "best," but rather to explain what they are and how they are used.

In phantom stock, it was noted that this plan gave some of the advantages of stock ownership but does not result in any stock transfer. There is no risk to the employee and the performance shares are paid out of dividends. This plan is advantageous to the employee for tax purposes since there normally is no tax payment until after retirement and then at ordinary income rates. It motivates executives by attempting to encourage continuity of employment. The implications for the employer are that it does not have to transfer ownership and it is tax deductible when paid out.

The stock option is perhaps the most widely used form of executive compensation. There are also innumerable variations of this plan. The executive can benefit by owning a portion of the company and once the option is exercised it can not be terminated. Although this is a personal type of motivation, the plan has been adversely affected by the Tax Reform Act of 1969. Although it must transfer ownership and the stock is not tax deductible, it does provide the company an alternate means of raising funds.

The stock warrant plan may be used like a stock option or the warrant itself can be sold by the employee. It is advantageous to the employee because if exercised, it can not be terminated and it is a personal motivation. It is advantageous to the employer because it has the potential for raising capital.

The stock bonus plan provides for the giving of the shares of stock to an executive as part of his total compensation. It is advantageous to the employee because he is given ownership in the company and taxed as ordinary income. It is advantageous to the company because this plan can easily be tied to the "profit-center" approach to measuring executive performance.

The stock purchase plan, although normally open to all employees, transfers ownership, can not be terminated, and may be paid for by payroll deductions. For the company, this is the best of the four methods for raising capital and is normally free of administrative detail since this is normally handled through a stockbroker.

To give an encapsulated view of this entire paper, exhibits 1 and 2 are attached. The purpose of these exhibits are to highlight and to delineate the differences of the five basic plans discussed in this paper. Exhibit 1 will describe the implications of these stock plans from the point of view of the employee. Exhibit 2 will describe the implications of these plans from the point of view of the employer.

EXHIBIT 1

IMPLICATIONS FOR EMPLOYEE

Type of Plan / Bases For Comparison	Phantom Stock	Stock Options a. Option	Stock Options b. Warrants	Stock Bonus	Stock Purchase
Transfer of Ownership	No	Yes; if exercised or option can be transferred to estate.	Yes; if not sold to third party	Yes; has mortality transfer.	Yes
Effected by Market	No; paid out of Dividends	Yes	Yes	Yes	Yes
Cost or Risk to Employee	None	Yes; if exercised	Yes	Yes	Yes
Duration of Bonus/Termination	May be terminated if executive's performance fails to measure up or employment is terminated	May not be terminated if exercised.	May not be terminated if already bought or sold.	May not be terminated	May not be terminated

IMPLICATIONS FOR EMPLOYEE

Type of Plan / Bases For Comparison	Phantom Stock	Stock Options a. Option	Stock Options b. Warrant	Stock Bonus	Stock Purchase
Taxation: Ordinary vs. Capital gains	Normally pays no tax until after retirement, then at ordinary income rates.	Taxed as tax preferrance income even though he has to wait 3 years to sell for capital gains	If exercised, taxed as capital gain	Taxed in year of receipt. Taxed as ordinary income and valued at market price	Works on before tax-earning dollar. Can be either income tax free or estate free basis.
Scope of Participation	Executives	Normally limited to top echelon of management	Executives	Executives	In many cases, must be open to all employees.
Duration of Payment or Option	Varies	Can be up to 10 years	Varies	May vary Considerably	Can be immediate or by payroll deductions
Type of Motivation	Encourages Continuity of Employment.	Has personal meaning.	Has personal meaning	Now mostly related to "profit-center" concept	Although gives ownership it is not personal because it is normally open to all employees. Encourages continuity of employment.

EXHIBIT 2

IMPLICATIONS FOR EMPLOYER

Type of Plan / Bases For Comparison	Phantom Stock	Stock Options		Stock Bonus	Stock Purchase
		a. Option	b. Warrant		
Company ownership transferred	No; paid out of dividend	Yes; if exercised	Yes; if exercised	Yes	Yes
Potential for Raising Capital	None	Yes	Yes	Yes	Best of the four methods for raising capital
Provides incentive to management	Yes; on an individual basis	Yes; on an individual basis	Yes; on an individual basis	Yes;on an individual basis	Yes; but normally open to all employees
Cost to firm/ ease of Administration	Tax deductible when money paid out. Must be kept in bookkeeping units.	Not tax deductible	Not tax deductible	Details normally done by the company. Common stock generally offered.	Firm usually free of administrative details. Handled by stock broker. (Only nominal Service Charge). Works on before tax-earning dollars

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