# Long-term Executive Compensation Alternatives

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<td><strong>Incentive stock option</strong></td>
<td>• A right granted by an employer to an executive to purchase company stock at a stipulated price during a defined period of time. Executive must not dispose of stock sooner than two years after option has been granted or one year after stock has been acquired through exercise.</td>
<td>• Option price must equal or exceed fair market value (FMV) of stock on grant date. • Options have a maximum 10-year life. • Payment that employee makes on exercise date for option stock can be made in cash or previously acquired stock. • $100,000 limitation on total amount that first becomes exercisable in a given year. • There are special rules for 10% or greater shareholders. • Plan approval by shareholders is required.</td>
<td>• Compensation expense is recognized with the award of an ISO based on the option's &quot;Black-Scholes&quot; or &quot;binomial&quot; valuation.</td>
<td>• No FICA payable.</td>
<td>• At grant — No tax liability (unless option is traded). • At exercise — No tax liability (gain is an AMT preference). • At disposal — All appreciation in excess of option price is taxed as capital gain. • Taxed like a NQSO if holding periods are not net (disqualifying disposition).</td>
<td>• At grant — No tax deduction. • At exercise — No tax deduction. • At disposal — No tax deduction unless disqualifying disposition does occur. Company can then deduct (as compensation expense) amount equal to what executive recognizes as ordinary income.</td>
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<td><strong>Nonqualified stock option (NQSO)</strong></td>
<td>• A right granted by an employer to an executive to purchase company stock at a stipulated price during a defined period of time.</td>
<td>• Option must be granted at a price equal to or above fair market value (409A). • Option term normally ranges from five to 10 years. • Previously acquired company stock may be used as payment on exercise. • Typically, plan approval by shareholders.</td>
<td>• Compensation expense is recognized with the award of an option based on the option’s “Black-Scholes” or “binomial” valuation.</td>
<td>• FICA payable at exercise.</td>
<td>• At grant — No tax liability(^1). • At exercise — Excess of fair market value over option price taxed as compensation (ordinary income). • Subject to tax withholding. • At disposal — Excess of fair market value over price at exercise taxed — often as capital gain.</td>
<td>• At grant — No tax deduction. • At exercise — Tax deduction available equal to amount of executive’s recognized income. • At disposal — No tax deduction.</td>
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<td><strong>Restricted stock</strong></td>
<td>• Shares of stock are granted outright to executives subject to certain restrictions. As these restrictions lapse (generally a period of continuous employment), shares are released to the executive.</td>
<td>• Executive typically holds the stock and is entitled to voting rights during restriction period. • Minimal or no executive financing is typically required. • This can tie restrictions to company goals. • Dividend equivalents can be paid or credited to the executive’s account. Typically, plan approval by shareholders.</td>
<td>• Compensation expense is generally accrued in a straight-line manner over the service period. Total expense is equal to the share value on grant date times the number of awarded shares. Since the expense is fixed, the tax deduction could be larger based on value when the restriction lapses. Excess benefit is credited to paid-in-capital.</td>
<td>• FICA is payable at the time restrictions on the shares lapse (vesting).</td>
<td>• When restrictions lapse, executive has compensation income taxed at ordinary income rates for excess of fair market value over cash paid (if any). • Subject to tax withholding. • Executive may elect within 30 days from grant date to be taxed on the stock value on the grant date (83(b)).</td>
<td>• When restrictions lapse, company is allowed tax deduction equal to compensation amount realized by executive. Company can also deduct dividends paid during service period as compensation. • If executive elects to be taxed within 30-day period from grant date, company is allowed an immediate deduction for the same amount (83(b) election).</td>
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1: If the option is traded, a tax liability can occur.
### Deferred Compensation

- **Description**: An account is established that receives periodic credits, or a benefit target is established. Performance period is usually about three to five years. Award is a known amount which varies according to degree of attainment of the goals. This can effectively link executive reward to the attainment of strategic goals.

- **Characteristics**: Annual credits based on business results or predetermined goals. Alternatively, a set benefit level or an increase in an established set benefit level. Performance period usually about three to five years. Award is a known amount which varies according to degree of attainment of the goals. This can effectively link executive reward to the attainment of strategic goals.

- **Accounting Treatment**: Compensation expense is accrued based on additional credits or in a straight-line manner over the service period for set benefits.

- **FICA Tax Treatment**: FICA payable at the time amounts become vested; however, for non-account balance plans, FICA can be deferred until amounts are ascertainable.

- **TAX TREATMENT: INDIVIDUAL**: Tax liability for amount of compensation received. Taxed as ordinary W-2 income.

- **TAX TREATMENT: COMPANY**: Tax deduction for amount of compensation at the time, generally, paid to executive.

### Performance Units

- **Description**: Units are granted by an employer to an executive, which entitle the executive to receive a cash award if specified financial goals are met during the performance period.

- **Characteristics**: Performance period usually about three to five years. Award is a known amount which varies according to degree of attainment of the goals. This can effectively link executive reward to the attainment of strategic goals.

- **Accounting Treatment**: Compensation expense is allocated over performance period. Expense is estimated each period by applying award formula against the current performance level.

- **FICA Tax Treatment**: FICA payable at the time amounts become vested.

- **TAX TREATMENT: INDIVIDUAL**: Tax liability for amount of compensation received. Taxed as ordinary W-2 income.

- **TAX TREATMENT: COMPANY**: Tax deduction for amount of compensation at the time, generally, paid to executive.

### Stock Appreciation Right (SAR)

- **Description**: Executive is granted an opportunity to realize appreciation in the price of a specified number of stock shares. Plan will have a specified maturity date.

- **Characteristics**: No executive financing required. Award may be made in cash, stock, or both. Plan approval by shareholders is typical. Employer may “cap” (designate a maximum) amount of appreciation available. Often granted in tandem with options. Right must be granted at a price equal to or above fair market value (409A).

- **Accounting Treatment**: Compensation expense is accrued equal to the excess of market value over the value on the grant date. Accruals occur over the term of the SAR and must be adjusted to reflect value of the stock.

- **FICA Tax Treatment**: FICA payable at the time amounts are paid to the employee.

- **TAX TREATMENT: INDIVIDUAL**: At exercise. Total value of appreciation is taxed as ordinary W-2 income.

- **TAX TREATMENT: COMPANY**: At exercise. Company has tax deduction equal to compensation income recognized by employee.

### Phantom Stock

- **Description**: Executive is granted units each of which are equal in value to one share of employer stock on grant date, or provide the opportunity to realize appreciation in the price of a specified number of stock shares. Plan will have a specified maturity date.

- **Characteristics**: No executive financing required. Award may be made in cash, stock, or both. Plan approval by shareholders is the norm. Employer may “cap” (designate a maximum) amount of appreciation available.

- **Accounting Treatment**: Compensation expense is accrued equal to the excess of market value over the value on the grant date. Accruals occur over the term of the deferral period and must be adjusted to reflect value of the stock.

- **FICA Tax Treatment**: Generally, FICA is payable at the time amounts become vested for full value shares, or the time paid for appreciation arrangements.

- **TAX TREATMENT: INDIVIDUAL**: Tax liability for amount of compensation received. Taxed as ordinary W-2 income.

- **TAX TREATMENT: COMPANY**: Company has tax deduction available equal to compensation amount realized by executive.