# EXECUTIVE COMPENSATION–
# A Total Pay Perspective

BRUCE R. ELLIG

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# About the Author

Bruce R. Ellig, a Phi Beta Kappa graduate of the University of Wisconsin, has a B.B.A., an M.B.A., and over fifteen years of compensation experience. He is Vice President of Compensation and Benefits, Corporate Personnel Division, Pfizer Inc., and is also responsible for the personnel portion of the company's computerized data system.

Among Mr. Ellig's professional activities are membership in the Conference Board's Council on Compensation and in NAM's Employee Benefits and Compensation Policy Committee. He is also Charter President of the New York Association of Compensation Administrators, Charter President of the Eastern Region of the American Compensation Association, and a past president of the New York Personnel Management Association. In 1976 Mr. Ellig participated in the Presidential Quadrennial Pay Commission study of employee benefit programs for top federal employees. In 1977 he served in a similar capacity for the city of New York, reviewing the pay of top elected and appointed officials. In 1980 he was chairman of a pay commission with a similar assignment. In addition, he has worked with the federal Council on Wage and Price Stability in establishing pay standards and with the U.S. Civil Service Commission in implementing the Civil Service Reform Act.

Mr. Ellig is a frequent speaker at personnel workshops, seminars, and conferences throughout the United States. He has taught at New York University and the New School for Continuing Education, has published articles in his areas of responsibility, has had his opinions widely quoted, and is coauthor of a book, *Compensation and Benefits: Analytical Strategies*, published by the American Compensation Association. He was a contributing author to McGraw-Hill's *Encyclopedia of Professional Management* and is now serving as consulting editor for AMACOM's *Compensation Review*.

The American Compensation Association has officially recognized Mr. Ellig as one of the country's leading compensation experts. He has also been awarded the Accredited Personal Diplomate certificate (APD)—the American Society for Personnel Administration's highest level of recognition for a compensation and benefits specialist.

# Preface

This book differs from others in that it attempts to cover all aspects of executive compensation. Some books focus on incentive pay, some on employee benefits. Others cover total compensation for all levels of an organization and therefore spend little time on the unique nature of executive pay. This book was written to fill what is perceived to be a specific void: the lack of information about total executive compensation.

Five basic elements of executive pay are examined: salary, short-term incentives, long-term incentives, employee benefits, and perquisites. The analysis points out the characteristics, strengths, and weaknesses of each element and shows how it can be combined with other elements to shape a total pay package.

The book is intended for three separate and distinct audiences: those designing executive pay programs, those responsible for the approval and maintenance of such plans, and those receiving executive pay—namely, the executives themselves.

In covering the subject of executive pay, the approach is multifaceted: clear definitions are given and each element of executive pay is examined in terms of tax, accounting, and SEC treatment. Furthermore, the elements of pay are viewed in relation to executive needs and company objectives; the role of the compensation committee in designing and administering the pay program is also discussed.

The material is presented in a manner that attempts to make a very "heavy" subject interesting. Where possible, definitions are supplemented with examples and charts. Tables are used liberally to help each reader apply the material to his or her own specific situation.

An impartial analytical style has been the intent throughout the book. Readers are cautioned that the book is *not* intended to advise and that, because of the technical and changing nature of tax, accounting, and SEC issues, specific situations should be reviewed by counsel before an action is taken. Also, all examples and specifics, unless otherwise noted, are fictional in nature. Any resemblance to actual companies, individuals, reports, or situations is purely coincidental.

The author is especially indebted to Mr. Donald C. Lum, Pfizer's Vice President of Personnel, for establishing an environment in which these and other ideas could be nurtured

and developed. However, the comments and views in this book are solely those of the author and in no way imply a position of Pfizer Inc. or its management. And a very special "thank you" to Dolores Poindexter. Without her assistance the book would not have been possible; she cheerfully deciphered illegible writing and turned it into typewritten prose.

**Bruce R. Ellig**

# Contents

# The Problem

Chapter 1

The plethora of articles and reports on the subject of executive compensation does more to confuse than to enlighten those who are not hip deep in the mainstream of compensation planning and administration. Each piece focuses on one aspect of top management pay with little attempt to place this aspect in proper perspective to the whole.

Not too surprisingly, some chief executive officers (CEOs) have thrown up their hands in disgust and adopted a plan one of their counterparts discussed across the luncheon table—or perhaps picked what appeared to be the best features of several plans.

This never ceases to amaze me. Each company proudly points to the results of its research function, its own marketing strategies, and its production process improvements but is willing to accept an incentive plan used by another company with little or no attempt to determine its appropriateness.

The basic objective should be to produce pay delivery systems which will result in compensation that is internally equitable (given assigned level of responsibility and degree of success in attaining it) and externally competitive (thus neither overpaying and misusing capital nor paying too little to attract and retain needed level of performer).

The procedures which ensure realization of the objective must be cost effective. Having nothing committed to writing is as bad as a bureaucratic function that is more interested in ensuring its own continuance (by developing increasingly precise rules which only it can interpret) than in optimizing the production of a viable pay delivery system.

In addition, the record-keeping ability of the company must be sufficient to allow it to produce data at a time and in a manner which enables one to make periodic assessments of the degree to which the pay objective (internally and externally) is being met. A computerized personnel data bank is the optimum, but admittedly for some organizations it may not be cost effective.

Chapter 1

## PAY COMPRESSION

The compensation program is a dependent, not independent, component of the organization. Its structure must be consistent with the organizational objectives and should facilitate their attainment and penalize their degree of failure. Usually this is a philosophy agreed to in principle but largely ignored (especially the aspect dealing with failure) in practice.

The problem is further complicated by the impact of collective bargaining agreements and increasing starting salaries for college graduates. They result in significant pressure to increase the lower end of the exempt salary structure. Conversely, public pressure on visible compensation for the five or so highest-paid executives serves to retard growth in the upper portion of the structure. This is illustrated in Figure 1-1. While the absolute increases are probably still greater at the upper portion than the lower end, the percentage increases are higher at the bottom of the structure. This results in a flattening or compressing of the salary curve (a perfectly flat curve would be parallel to the $X$ axis) and a diminishing in the amount of pay differentials for greater responsibility (i.e., job value). This is the effect called *pay compression*. Since this is a reduction of the differential between organizational levels, it is a phenomenon that can only be measured at two or more intervals in time. An additional factor contributing to compression is the introduction of additional layers of management, thus lessening the differential between organizational levels.

Many companies further compound the inequity by stretching out the salary review period to 15 months, 18 months, or even 2 years at the top of the compensation structure. While the increase given is larger than for annual reviews, rarely is it proportionately larger. In other words, instead of giving 18 percent after 18 months versus 12 percent after 12 months (for a given level of performance), the company is more likely to give

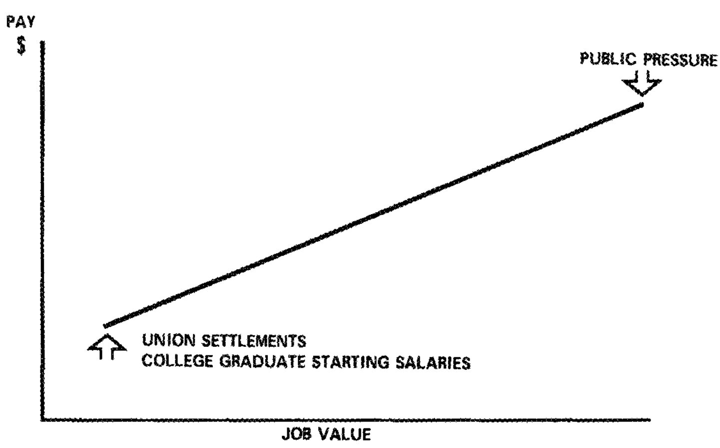


**FIGURE 1-1** Pay compression (public pressure versus college-union adjustments).

**TABLE 1-1** Ordinary versus Personal Service Income

| Taxable income | Ordinary income | | Personal service income | |
|---|---|---|---|---|
| | Taxes | After tax | Taxes | After tax |
| $ 50,000 | $ 14,778 | $ 35,222 | $ 14,778 | $ 35,222 |
| 100,000 | 41,998 | 58,002 | 39,678 | 60,322 |
| 150,000 | 74,868 | 75,132 | 64,678 | 85,322 |
| 200,000 | 108,772 | 91,228 | 89,678 | 110,322 |
| 250,000 | 143,740 | 106,260 | 114,678 | 135,322 |
| 500,000 | 318,740 | 181,260 | 239,678 | 260,322 |

15 percent after 18 months. One could argue that because the individual had to wait 6 months longer (a period during which another person already was enjoying the 12 percent increase) the increase should be somewhat greater than 18 percent, certainly not less.

Since little can be done to slow the growth at the bottom of the structure (as it would mean insufficient differentials between first-line supervisors and the union employees they supervise), compensation planners focus on devising less visible forms of pay for the senior executive (e.g., benefits and perquisites) and those which relate directly to performance (e.g., short- and long-term incentives) and where high payments can be explained in terms of specific performance.

This book therefore will deal not simply with the salary structure but also with the other four elements (i.e., benefits, perquisites, short- and long-term incentives). Each element will be defined and described. Emphasis will be not on a textbook definition but rather on how various forms relate in different manners to individual and organizational needs.

## TAX CONSIDERATIONS

In describing various forms of the five elements and how they may be employed, the tax treatment will be discussed, when the income is something other than straight personal service income (which is currently taxed at a maximum of 50 percent beginning at about $60,000 for a married person filing a joint return). This is not intended to be a book on taxation of executive compensation; therefore, the discussions will be supportive and illustrative rather than primary and exhaustive. However, the importance of considering taxes is demonstrated in Table 1-1, which reports the federal income tax (and after-tax income) at selected levels of taxable income, under the 1978 Revenue Act, for both ordinary and personal service income.

The pessimist at the $500,000 level cries about the $239,678 tax liability; the optimist rejoices over the $260,322 after taxes. Regardless of the perspective, one thing is clear: it is better now than it was previously. Namely, in 1964 the top marginal rate was reduced from 91 to 77 percent, the following year it was lowered to 70 percent, and in

**TABLE 1-2** Federal After-Tax Cost to Company

| | Status of $1.00 paid to executive | | |
|---|---|---|---|
| | No expense or tax credit | Tax deductible | Nondeductible |
| Company cost | 0 | $0.54* | $1.00 |

*Assumes 46 percent tax rate.

1969 the 50 percent maximum tax for wages was introduced. Furthermore, many countries abroad have tax rates more confiscatory than even our earlier policies.

In examining tax impact, it is appropriate to consider what is left after taxes. This after-tax examination can be done for both the executive and the company: the first is *after-tax value*, while the second is *after-tax cost*. Dividing the former by the latter, we achieve a numerical expression of *after-tax effectiveness*. Namely, to the extent the executive's after-tax value increases or the company's after-tax cost decreases, one has improved the after-tax effectiveness.

As shown in Table 1-2, the company essentially has three situations with regard to a compensation expense: no expense or tax credit, tax deductible, and non–tax deductible. The first says either there is no out-of-pocket expense or the expense is a tax credit and therefore reduces dollar-for-dollar its tax liability (truly a no-cost expense since the federal government is paying the full charge). If it is tax deductible, it reduces the company income before taxes dollar-for-dollar (here the federal government is a partner in paying the expenses). The worst situation is when the expense is nondeductible for tax purposes and the company therefore receives no tax assistance and bears the full expense of the payment.

The executive's after-tax value is dependent on the manner in which the expense is taxed. In the best situation it either is not taxed or, if taxable, is fully tax deductible and therefore cancels itself out (i.e., the amount is entered as income but income is then reduced by the amount of the deduction). The next best situation is long-term capital

**TABLE 1-3** Federal After-Tax Value by Type of Income

| | Net (after-tax) value of $1.00 | | | |
|---|---|---|---|---|
| Executive's taxable earnings | Nontaxable or taxable, but fully deductible | Long-term capital gains | Personal service income | Short-term capital gains or ordinary income |
| $250,000 | $1.00 | $0.720 | $0.50 | $0.30 |
| 200,000 | 1.00 | 0.728 | 0.50 | 0.32 |
| 150,000 | 1.00 | 0.744 | 0.50 | 0.36 |
| 100,000 | 1.00 | 0.764 | 0.50 | 0.41 |
| 50,000 | 1.00 | 0.804 | 0.50 | 0.51 |

gains (i.e., property held longer than a year), where 60 percent [illegible] is excluded and the remainder taxed as ordinary income. Short-term capital gains (i.e., income on property held 1 year or less), ordinary income, and personal service income are taxed exactly the same, except that personal service income has a maximum rate of 50 percent. This becomes important for a married person filing jointly with taxable earnings above $60,000, a single person with taxable income above $41,500, and a married person filing a separate return with taxable earnings above $30,000. Table 1-3 indicates the federal after-tax value of $1.00 for these different tax situations at selected income levels. State income tax, where appropriate, would further reduce the values.

### *Tax Effectiveness*

As indicated earlier, dividing the executive's after-tax value by the company's after-tax cost gives one a measurement of the tax effectiveness of the form of payment. The higher the value, the more tax effective the payment.

$$\text{Tax effectiveness} = \frac{\text{executive's after-tax value}}{\text{company's after-tax cost}}$$

By combining the three possibilities for net company cost with the four possibilities of net executive income at $250,000, it is possible to construct the matrix shown in Table 1-4. While similar matrices could be constructed for $50,000, $100,000, $150,000, and $200,000, they would be identical for the first and third columns. Throughout this report the values from the matrix in Table 1-2 will be used to illustrate tax impact. It should be remembered that if long-term capital gains or ordinary income are involved, a more precise measurement can be obtained by returning to Table 1-1.

The normal value is 0.93. This reflects a 50 percent personal service income tax for such payments as salary and bonuses with a corporate tax rate of 46 percent. Thus $0.50 after-tax value divided by a $0.54 after-tax cost equals 0.93. A low value for a $250,000 executive would be 0.30 such as would be derived from stock dividends since they are taxed as ordinary income to the executive and are *not* tax deductible to the company. The importance of salary not being a non–tax deductible dividend to a small company executive-shareholder is quite apparent. Even if successfully identified as personal service

**TABLE 1-4** After-Tax—Company Cost versus Employee Value

| Company's after-tax cost | Executive's after-tax value of $1.00: Nontaxable or taxable but fully deductible | Long-term capital gains | Personal service income | Short-term capital gains or ordinary income |
|---|---|---|---|---|
| No expense | ∞ | ∞ | ∞ | ∞ |
| Deductible | $1.85 | $1.33 | $ .93 | $0.56 |
| Nondeductible | 1.00 | 0.72 | 0.50 | 0.30 |

income, it is important that it not be deemed unreasonable compensation by the Internal Revenue Service (IRS), for it would then move from a 0.93 (i.e., $0.50 divided by $0.54) to a 0.30 for a highly paid executive (i.e., $0.30 ordinary income divided by $1.00 since unreasonable compensation is not tax deductible).

The maximum value is infinity, determined by dividing $1.00, $0.72, $0.50, or $0.30 by zero cost. However, very few items are both income to the executive and no cost to the company. One example is when an executive travels on a company plane for pleasure by merely taking an empty seat on a business trip to the same location; certainly there is no additional out-of-pocket expense to the company, yet there is a definite after-tax value to the individual.

In addition to direct pay (or fair market value for such things as stock awards), executives must be familiar with several taxable situations, namely constructive receipt, economic benefit, and imputed income.

*Constructive receipt* occurs when the executive had the right to take the pay currently but chose to defer it or to accept it in some other form. Simply turning one's back on the offered compensation is not sufficient to avoid constructive receipt (i.e., being taxed as if it were received). A more detailed explanation of this principle is found in Chapter 9, Deferred Compensation. *Economic benefit* is closely allied with the doctrine of constructive receipt. The former is usually invoked when the company funds a future payment to the executive through an insurance contract or trust. In these situations the individual will be taxed on the annual value of the employer contributions even though the principle of constructive receipt was not invoked. This point is also covered in more detail in Chapter 9. *Imputed income* occurs when the value of a service is estimated (e.g., personal use of corporate aircraft). The value may be the actual cost to the company or, in some instances, the value of a comparable service through other means (e.g, the cost of first-class commercial air fare). The impact of imputed income is discussed in some detail in Chapter 6, Perquisites.

## SEC DISCLOSURE REQUIREMENTS

In addition to being familiar with the tax aspects of various forms of compensation, it is important to be aware of the Securities Exchange Commission (SEC) requirements of disclosure. Currently these apply individually to the five highest-paid executive officers or directors earning more than $50,000 per annum, as well as to the officers and directors as a group. The requirements for the remuneration table are identified by columns:

**Column A:** Name of individual or number of persons in group

**Column B:** Capacity in which persons served

**Column C:** Cash and cash-equivalent forms of remuneration

**Column $C_1$:** Salaries, fees, commissions, and bonuses

**Column $C_2$:** Securities or property vested or received, insurance benefits or reimbursement, and other personal benefits

**Column D:** Aggregate of contingent forms of remuneration

Thus it can be seen that columns C and D are the compensation columns. The determining factor of where an item is reported is whether or not a contingency exists as to payment. If so, it is reportable in column D. If no contingency exists, regardless of whether received or not, it is reportable in column C. Thus, vested and deferred compensation with no forfeiture features is reportable in column C. Compensation previously reported in column D logically would not be reported in column C when actually received. Also, the cost of perquisites should be included in column C unless the value cannot be obtained without reasonable effort and expense, the cost is not greater than $10,000 per individual, and omission is not misleading.

Beginning with the 1981 proxy season, the SEC decided that stock options and stock appreciation rights should be described in separate tables, rather than being included in columns $C_2$ and D of the remuneration table. In addition, a separate table is required for defined benefit plans whose amounts are not included in the remuneration table.

## WHO IS AN EXECUTIVE?

It's important to clarify that definition quickly since this is a book on executive compensation. On one hand we have the definition of executive provided by the Fair Labor Standards Act, which specifies those jobs exempt from overtime pay. Its requirements, supervising at least two full-time subordinates in a position customarily requiring the exercise of independent judgment and discretion, could be assumed to mean that any supervisor earning approximately $15,000 or more would be an executive. Conversely, some insist that the definition applies only to corporate officers. Both positions are extremes. Certainly a significant portion of this book is directed solely to divisional officers and even higher ranks, but in most organizations many aspects of the pay discussion will be applicable several layers below these levels.

An "executive" for purposes of this book is any individual in a managerial position within the organization who is probably in the highest-paid 2 to 3 percent of the company's total employee population or the highest-paid 5 percent of the exempt portion of the work force.

# The Compensation Elements

Chapter 2

There are five basic compensation elements: salary, employee benefits, short-term incentives, long-term incentives, and perquisites. As shown in Figure 2-1 only salary and employee benefits are a factor at the lower portion of most organizations; however, all five are present at the CEO level—each of the other three being phased in at different points in the organization.

The objective of the *salary* element is to reflect extent of experience and sustained level of performance for a job of a particular level in importance to the organization. It is also the basis on which the other four elements are based. For many, salary is the income level which will allow the executive to meet many but not all of his or her lifestyle objectives. For that, the individual must also successfully meet short- and long-range incentive objectives (and resulting payouts). The latter keeps the executive "at risk." However, since incentives are essentially nonexistent in some industries and in nonprofit organizations, the salary program takes on added importance in adequately reflecting short- and long-range contributions to the organization.

The *employee benefits* element deals with providing time off with pay, employee services, nonperformance awards, health care, survivor protection, and retirement coverage to all employees in the organization. The extent of coverage is determined by years of service and/or level of pay.

The *short-term incentives* are designed to reward the extent of accomplishment of a short (normally yearly) target. Typically, the amount of payment goes up and down each year in relation to performance.

The *long-term incentive* is similar to the short in objective except it is multiyear (typically 3 to 5). The incentive award by definition means the executive has a portion of pay placed "at risk" with degree of attainment of objectives. Not meeting the expected target calls for no bonus or low bonus, a form of punishment short of termination of employment.

*Perquisites* are employee benefits which are designed only

Chapter 2

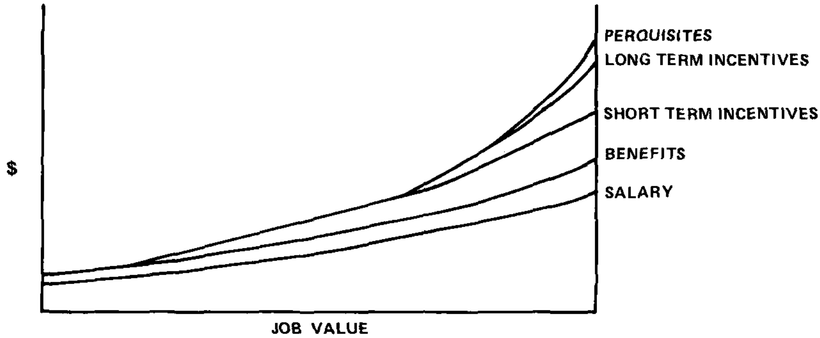


**FIGURE 2-1** Total compensation (five element curves).

to apply to executives. In some instances, they merely supplement employee benefit coverage, in other instances they provide coverage which does not exist in the employee benefit program.

As depicted in Figure 1-1 the progression on pay is nonlinear. The pyramidal structure of the company means an arithmetic increase in responsibility (a promotion) and a geometric decrease in the probability of receiving an additional one. Thus sufficient room must be allowed in the pay for the job to reflect longer "rest intervals" at each succeeding grade. By definition when the person has been promoted to CEO the individual has exhausted his or her career potential in that company! The structure must take into account and provide sufficient stretch for compensation growth for performance.

As seen in Figure 2-1, but perhaps more clearly in Table 2-1, these elements of compensation take on different emphasis at different levels in the organization. For example, at the $50,000 total compensation level, 65 percent (i.e., $32,500) might be in salary, 10 percent (i.e., $5000) in short-term incentives, 2.5 percent (i.e., $1250) in long-term incentives (maybe all in a stock option), and 22.5 percent (i.e., $11,250) in employee benefits.

**TABLE 2-1** Possible Compensation Distribution of Five Elements

| | Total compensation | | | | |
|---|---|---|---|---|---|
| | $50,000 | $100,000 | $250,000 | $500,000 | $1,000,000 |
| Salary | 65 % | 60% | 50 % | 40% | 30 % |
| Short-term incentive | 10 | 15 | 20 | 20 | 20 |
| Long-term incentive | 2.5 | 5 | 10 | 20 | 30 |
| Employee benefits | 22.5 | 20 | 17.5 | 15 | 12.5 |
| Perquisites | — | — | 2.5 | 5 | 7.5 |
| Total | 100 % | 100% | 100 % | 100% | 100 % |