

COMMENTS FROM



Volume 3, Issue 1

INSIGHTS FOR INFORMATION TECHNOLOGY FIRMS

Reasonable Compensation

The issue of reasonable compensation, which has long been dormant, is receiving renewed attention from the IRS.

For business owners, there is a tax advantage to taking money out of a corporation, as either salary or bonus, rather than as a dividend. A corporation can deduct the compensation that it pays, but not its dividends. Thus, if funds are withdrawn as dividends, they are taxed twice, once to the corporation and once to the recipient. Money paid out as compensation is taxed only once, to the employee who receives it.

However, there is a limit on how much money can be taken out of the corporation in this way. The law says that compensation can be deducted only to the extent that it is reasonable.

How much compensation is 'reasonable'? There is no (continued on Page 3)

Incentive Stock Options (ISOs)

We frequently receive inquiries from clients in connection with the granting of incentive stock options (ISOs) on its stock. The ISO gives the recipient the right to buy a predetermined number of shares of the company's stock at its fair market value at the time of the ISO's grant for a period following the grant.

The grant of the ISO will not be taxable. Nor will the option holders later exercise of the ISO (except that it may result in an alternative minimum tax, see below). For example, if the fair market value of the stock at the time of the grant is \$100 per share and market value of the stock rises to \$150 per share, when the option is exercised and 1,000 shares of stock with a market value of \$150,000 are purchased for \$100,000 there will not be a regular income tax on the \$50,000 bargain purchase. When the stock is later sold, say when its value reaches \$200 per share, for (continued on Page 2)

Inside This Issue...

Reasonable Compensation	1
Incentive Stock Options	1
Survey of IT Firm Operating Results	3
Speeches and Seminars	3
Can We Help You?	4

THE CHALFIN GROUP INC.
45 Bridge Street
P.O. Box 4519
Metuchen, NJ 08840-4519
732-321-1099
732-321-1066 (facsimile)
www.chalfin.com

This information is designed to be accurate and authoritative; however, this publication is distributed with the understanding that it does not render legal, accounting or other professional advice, and no liability is assumed in connection with its use.

ISOs

(Continued from Page 1)

\$200,000, the \$100,000 profit will be taxed as a capital gain in the year of sale.

To qualify for the favorable tax treatment available with an ISO (so the \$100,000 employment-related profit is taxed at capital gain rates rather than at the higher ordinary income tax rates imposed on regular compensation), a 'disposition' of the stock cannot be made: (1) within two years after the ISO is granted, or (2) within one year after the stock has been transferred to the option holder. A 'disposition' includes a sale, exchange, gift, or similar lifetime transfer of legal title.

If the stock is disposed of before both of the required holding periods have expired, the individual will be taxed as if he/she had received compensation in the disposal year. The gain on that premature disposition will be treated as ordinary income to the extent of the lesser of: (1) the fair market value of the stock on the date of exercise minus the option price, or (2) the amount realized on the disposition minus the option price.



For example, assume again the option holder buys \$150,000 worth of his or her company's stock for \$100,000 by exercising the ISO and later sells this stock for \$200,000. The spread between the value on the date of exercise (\$150,000) minus the option price (\$100,000) is \$50,000. The difference between the amount realized on the disposition of the stock (\$200,000) minus the option price (\$100,000) would be \$100,000. Consequently, the \$100,000 gain on the premature disposition would be ordinary income to the extent of \$50,000 (the lesser of \$50,000 or \$100,000).

If the stock declines and the option holder receives less on the premature disposition than the value when the ISO was exercised (and the disposition wasn't a sale to a related taxpayer), then the taxable amount is limited to the amount

realized on the sale minus the adjusted basis in the stock. For example, if the stock is sold for \$130,000, then there would be \$30,000 of compensation income (\$130,000 amount realized less \$100,000 adjusted basis).

Although the ISO can have different exercise periods, the tax rules that apply to ISOs require the option be exercised no later than three months after employment is terminated. There are some exceptions to this employment requirement if the termination involves a transfer to a related company (e.g. a parent or subsidiary).

The special tax treatment allowed to taxpayers for regular tax purposes when an ISO is exercised (i.e. no taxation at the time the ISO is exercised, deferral of tax of the benefit associated with the ISO until disposition of the stock, and taxation of the entire profit on the sale of stock acquired through ISO exercise at capital gain rates if ISO holding periods are met) is not allowed for alternative minimum tax (AMT) purposes. Under the AMT rules, the value of the stock acquired through an ISO exercise (reduced by the option price you paid) must be included in alternative minimum taxable income in the year the stock became freely transferable or was not subject to a substantial risk of forfeiture. These potential AMT consequences could diminish some of the tax benefits of an ISO.

Clearly, the incentive stock option rules are both technically complex and call for some careful tax planning strategies. Other types of options such as non-qualified options have different requirements. If you would like to discuss this in more detail, please contact us.

Future Mailings

Please let us know if your address is incorrect or if there is someone else you know who would like to be added to our mailing list. Please contact us if you would like to receive future issues of this publication via email at services@chalfin.com.

This information is designed to be accurate and authoritative; however, this publication is distributed with the understanding that it does not render legal, accounting or other professional advice, and no liability is assumed in connection with its use.

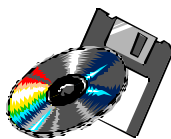
Reasonable Compensation (Continued from Page 1)

simple formula. The IRS tries to determine the amount that similar companies would pay for similar services, taking into account the business owner's duties, abilities, and accomplishments.

Recently, the IRS has taken a special interest in raising reasonable compensation issues during an audit. This means business owners must take extra care to prove the compensation they receive is reasonable.

This can be done in several ways. In some cases, it is a matter of proving that the compensation received is on a par with other executives in the same industry. In other cases, it can be shown that the business owner has special skills or has made special efforts that justify his or her salary.

Call us if you would like to discuss this or any other aspect of your compensation planning.



Speeches and Seminars

Employees of The Chalfin Group frequently speak to business groups. Some of our recent topics have included:

- Benchmarks For Managing Software Company Growth
- How Much Is Your Software Business Worth and What Can You Do To Increase Its Value?
- How Investors Really Evaluate a Software Company's Financials

Please contact us if you would like a copy of the handouts from any of these speeches. We are also available to speak to your group.

Survey of Information Technology Firm Operating Results

The Chalfin Group's 1998 Survey Of Information Technology Firm Operating Results was released on September 28, 1998. This is The Chalfin Group's fourth annual survey, and it is our biggest and most extensive survey ever.

The Survey provides information on topics that are important to the operation of IT firms including:

- Revenues
- Sales/Employee
- Profits
- Compensation Costs
- Officers' Compensation
- Bonus and Equity Sharing
- Billing Rates
- Lines of Credit
- Maintenance Fees
- Deposits at the Time of Contract

As was the case in the past, the Survey results were grouped and reported in the following categories: firm revenues, number of employees, profitable versus not profitable firms, firm type, and past and expected future growth rate.

On average, respondents expected to hire over 13 employees in 1998, and their average revenues were over \$5 million in 1997. Just over 60 percent of the respondent firms were profitable.

By firm type, the largest component was industry specific software firms who comprised 58.11 percent of respondents. The next largest firm type were professional service firms which comprised 21.62 percent of the respondents, cross industry application software firms comprised 13.51 percent of the respondents and system software firms amounted to 5.41 percent of the respondents.

Over one-half of the respondents had a business partner or reseller affiliation with IBM. The next highest affiliation was with Microsoft with whom just under 30 percent of the respondents reported a relationship. If you would like to order the Survey, or view the table of contents, please visit our web site at www.chalfin.com

This information is designed to be accurate and authoritative; however, this publication is distributed with the understanding that it does not render legal, accounting or other professional advice, and no liability is assumed in connection with its use.

Can We Help You?

The Chalfin Group provides strategic planning and valuation services to information technology firms. This includes advisory services relating to the purchase and sale of information technology firms. If you would like more information on any of the following services our firm provides, please check the appropriate boxes below and return this page via facsimile to 732-321-1066 or email your request to services@chalfin.com.

Services

- Advisory services relating to the purchase and sale of information technology firms
- Positioning companies for sale
- Business valuation
- Programs to increase the value of your business
- Business and strategic planning
- Structuring compensation and long-term incentive plans

The Chalfin Group Inc.
45 Bridge Street; P.O. Box 4519
Metuchen, NJ 08840-4519
www.chalfin.com

BULK MAIL
US POSTAGE
PAID
METUCHEN, NJ
PERMIT NO. 6

ADDRESS CORRECTION REQUESTED

This information is designed to be accurate and authoritative; however, this publication is distributed with the understanding that it does not render legal, accounting or other professional advice, and no liability is assumed in connection with its use.