



FINANCIAL

Planning for Business

A Tax, Financial, & Investment Report

WestPoint *Private client*

G R O U P



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Effective Cost Management Builds a Solid Foundation

From the smallest proprietorship to the largest international conglomerate, cutting costs can often be perceived as a “quick fix” toward improving financial results. However, such business decisions may not always be in the best *long-term* interest of an otherwise healthy company.

Many business owners react to unexpected pressures by reducing costs without a definite plan of action; their course is *reactive* instead of *proactive*. However, this “strategy” may become random and shortsighted unless it’s based on a company’s **business plan**.

While an immediate need may appear to have been alleviated, in some cases only the *symptoms*—rather than the real problems—may have been addressed.

Taking Control

A better plan of action focuses on *managing* rather than simply *cutting* costs. The difference is more than a matter of semantics. Managing costs is the *proactive* process of consciously choosing to spend in areas designed to produce a positive financial result; while cutting costs is a *reactive* process, which

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Employee Stock Options

The fundamental role of **employee stock options** is to align management’s profit incentives with those of shareholders. Companies provide opportunities for their employees to obtain company stock as an incentive for them to become “owners” of the company and, as a result, *directly* benefit when the value of the company stock rises.

Employee stock option plans give employees the right to purchase shares (usually at a future date) at a pre-set price. These plans differ from **employee stock ownership plans (ESOPs)**, which

are defined contribution retirement plans subject to special Internal Revenue Service (IRS) rules for qualified pension plans.

Employee stock options may be either **statutory** or **nonstatutory**, the main difference being the tax consequences when an option is exercised. Statutory stock options come in two varieties: **incentive stock options (ISOs)** and options granted under **employee stock purchase plans**. In both plans, there are no tax consequences when an option is granted.

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Paid Time Off for Workers Can Pay Off for Employers

Under pressure to balance work, family, and other personal commitments, paid time off is among the benefits employees value most. Given the choice between an extra week of vacation time and an additional week's pay, around half of American workers would opt for more time away from their jobs, according to the results of the quarterly CNBC Wealth in America survey released in June 2007.¹

Employers in the United States are generally under no legal obligation to offer paid leave to workers. But, as a business owner, you will likely find it difficult to attract and retain skilled employees without providing paid vacation, holidays, and sick days.

The most common practice among U.S. employers is to provide employees with a minimum of ten paid vacation days after six to twelve months with the company, and three weeks after five years of service. Some companies also offer a fourth and a fifth week of vacation after a decade or more. Because many organizations use this seniority system, providing workers with progressively more vacation time can act as an incentive for long-serving employees to remain with the company. Extra paid vacation days may also be offered as a performance-related bonus.

As well as giving workers the rest they need to

recover from an illness, paid sick leave discourages employees from coming to work when contagious and unproductive. Companies typically offer between four and ten days of sick leave a year, sometimes more based on the seniority or rank of the employee. To better manage the cost of providing an income to employees when they are unable to work due to a serious illness or injury, consider enrolling employees in a short-term and/or long-term disability income insurance.

There are certain types of leave that most employers are legally obligated to allow, though these may be unpaid. Employers must, for example, permit workers to take time off to vote, serve on a jury, and fulfill military training commitments. Under the Family and Medical Leave Act (FMLA), organizations with 50 or more employees are required to grant eligible employees up to 12 weeks a year to recover from a serious illness, to care for a sick family member, or to handle the birth or adoption of a child. States and cities may also require employers to provide workers with additional forms of unpaid leave.

Instead of allotting a certain number of days for each type of paid leave, you may want to consider establishing a "paid time off" (PTO) bank. Companies with a PTO policy combine vacation, sick time, and other forms of

leave other than paid holidays into a single bank of days. Employees can use these days at their own discretion, and they are not required to specify whether they are taking vacation, a personal day, or sick leave. Compared with traditional leave programs, PTO banks offer workers greater flexibility and autonomy, making it less likely that healthy employees will call in sick at short notice for personal reasons or take advantage of unused sick leave. PTO banks are also easier for employers to effectively manage and administer.

There are some potential disadvantages to moving to a PTO bank, including the possibility that employees who would not otherwise use all of their sick days will end up taking more time off. Workers also tend to view their PTO allotment as vacation time, and they may come to work sick to avoid using their paid time off. On the other hand, the perception that a company offers a large number of days that could be used for vacation can give the organization a competitive advantage in attracting qualified employees, especially young people who appreciate having time for recreation but do not expect to get sick.

In developing a paid time off benefit program, you should attempt to balance both the needs of the business and the interests of your staff. To minimize



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Employee Stock Options

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ISOs vs. Employee Stock Purchase Plans

ISOs may be issued selectively and are usually granted to key employees. Taxable income is generally not realized when an ISO is granted or exercised, but rather when the stock acquired through an ISO is sold. However, the “bargain element” (i.e., the difference between the option price and the **fair market value (FMV)** of the stock at the time the employee’s rights in the acquired stock became transferable or were no longer subject to a substantial risk of forfeiture) is generally a tax preference item for the **alternative minimum tax (AMT)** for the tax year in which the ISO is exercised—unless the stock is acquired and sold in the same year.

If at the time of sale more than two years have expired since the option was granted *and* more than one year has expired since the option was exercised, then *all* of the employee’s gain, if any, is **capital gain** subject to the capital gains rate of 15% for taxpayers in the top four brackets. If these two holding period requirements are *not* satisfied, the gain is taxed as ordinary income (to the extent of the excess of the lesser of either the amount realized upon disposition or the FMV of the stock on the date the option was exercised over the option price) at rates up to 35% depending on the taxpayer’s marginal tax rate. Any additional gain on the disposi-

tion of the stock receives capital gain treatment.

Employee stock purchase plans allow employees to purchase company stock at a discount and may provide certain tax benefits. These plans must be nondiscriminatory (i.e., cannot be issued selectively), and there are no AMT consequences when the option is exercised. As with ISOs, no income is realized when an option is granted or exercised.

If, at the time of sale, more than two years have elapsed from the time the option was granted—and more than one year has expired from the date of exercise—generally gain (to the extent of the excess of the lesser of either the amount realized upon disposition or the FMV of the stock when the option was granted over the option price) is treated as ordinary income. Any additional gain receives capital gain treatment. If both holding period requirements are not met at the time of sale, the difference between the FMV of the stock on the date of exercise and the option price is treated and taxed as ordinary income, subject to the taxpayer’s marginal tax rate (up to 35%). Any additional gain on the disposition of the stock receives capital gain treatment.

Nonstatutory Stock Option Plans

Nonstatutory stock options differ from statutory stock options in that either the granting or exercising

of such an option may be a taxable event. If, at the time the option is granted, the option has a readily determinable FMV, the employee must recognize ordinary income in the amount of the FMV of the option (when substantially vested), less any amount paid for the option, in the year the option is granted. There will be no tax consequences upon exercise of the option.

If the option has no readily ascertainable FMV, the option is taxable income for the employee at the time the option is exercised. The employee must recognize ordinary income in the amount of the FMV of the stock purchased minus any amount paid for the stock or the option. Any amount included in income during the year of grant or of exercise will be *added* to the basis of the stock acquired.

Know Your “Options”

Employers view stock options as incentives that provide employees with the opportunity to share in ownership at discount values. Certain tax laws govern these benefits, and this article offers only a brief discussion of the regulations. A qualified tax professional can offer specific guidance. Before taking company stock, be sure to take “stock” of your options! s



Effective Cost Management Builds a Solid Foundation

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typically happens when things seem to be getting “out of control.”

While both strategies entail eliminating waste, *effective* cost management relates costs to profits, whereas cost cutting is not necessarily closely correlated to profits. A haphazard approach can result in the illusion of a better bottom line, when in fact productivity and profitability may suffer.

Building Blocks for an Action Plan

Define the Relationship Between Costs and Revenues. What are your sources of income? Some businesses are product-based, while others are service-oriented. Or, your business might depend on a combination of products *and/or* services. Once you understand your revenue structure, you must become aware of the costs entailed in generating the revenue stream. Which costs are

directly related to producing revenue, and which are general overhead?

Reduce Inter-Departmental Complexity. In any company or organization, the operations of one department affect the others. Is the work being accomplished efficiently? Are there extra or unnecessary steps in the process? Are people communicating effectively?

Encourage Employee Involvement. Most employees have expertise in what they do because they do it every day. Establish rapport by seeking their advice and tapping into their creativity. Ask your employees for input into the decision-making process. By soliciting their suggestions on how to deal with specific cost problems, you will be giving them more incentive to become part of the solution.

Assess Decisions against Your Strategic Business Plan. Cost management decisions should

be measured against your long-term business strategy, rather than within the confines of a short-term situation. For example, if one of your suppliers has reduced prices to get rid of excess inventory, what are you accomplishing if you buy more than you need to satisfy *your* customers? How will your cash flow be affected? Will *you* be stuck with excess inventory if the market changes unexpectedly?

Discipline Can Pay Off

In our competitive and unpredictable economy, the need for efficient and effective cost management is a necessary ingredient in developing and fostering a successful long-term business. By knowing your true costs, and linking them to the bottom line on an ongoing basis, you will be in a better position to balance the varied and competing pressures for your financial resources. §

Paid Time Off for Workers Can Pay Off for Employers

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unscheduled absences and avoid abuses of paid leave benefits, establish clear guidelines on when, and under what conditions, employees are permitted to take leave. On the other hand, you may find it necessary to structure your

program to encourage hardworking employees to take time off to rest and recuperate.

If workers appear to be taking too much or too little time off, examine the reasons why. Employees who are shirking their

responsibilities or who, conversely, feel they cannot afford to take a vacation are often signs of a company culture in need of an overhaul. §

¹<http://www.msnbc.msn.com/id/19462966>

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