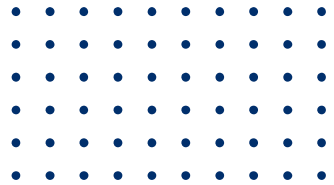


# Is Reasonable Compensation Really Reasonable?

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# Learning Objectives and Data Sources



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## Learning Objectives

- What is "Reasonable Compensation"?
- When to adjust for Reasonable Compensation
- Sources for Reasonable Compensation Data
- How to use Reasonable Compensation Data Appropriately
- Are BV Experts qualified to opine on Reasonable Compensation
- Does adjusting for Reasonable Compensation in a Business Valuation result in "Double Dipping"?

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## What is Reasonable Compensation?

Reasonable compensation is typically a normalizing adjustment taken when an owner, key executive or officer is determined to be overpaid or underpaid.

- Reasonable compensation adjustments are most often made for controlling interests since only controlling owners can unilaterally make compensation adjustments.
- However, in dissenting shareholder cases, courts often allow adjustments for reasonable compensation.
- There are three primary ways to determine reasonable compensation:
  - Multifactor Test
  - Compensation Surveys – Including public company datasources
  - Reasonable Investor Test

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## When do you adjust for Reasonable Compensation?

- Typically, in control situations:
  - Control owners can make adjustments; minority owners cannot (usually)
- When reported compensation is either above or below market rates
  - When valuing a business
  - When determining goodwill
  - In litigation involving a minority shareholder
  - In litigation involving separate v. community issues in a divorce

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## Five Sources of Reasonable Compensation Data

- Benchmarking Surveys
- Subscription Databases
- Proxy Statements
- Online Databases
- Government Statistics

A combination of sources is often best since different sources use different gathering techniques.

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## Benchmarking Surveys

Typically compiled by industry associations or consulting firms:

- Chief Executive Research – CEO Compensation
- Milliman
- American Salaries and Wages Survey – Gale Research
- PitchBook – Thelander Private Company Compensation Survey
- Executive Insight – Equilar
- Association of Corporate Counsel Members – Law Department Compensation Report – Large, Medium, Small
- Pearl Meyer – Compensation Consulting Services
- Spring Associates – Public Relations Salary Surveys

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## Benchmarking Surveys, cont.

- Altman Weil, Inc. – Compensation Services
- Buck – Consulting and Actuaries
- Medical Group Management Association
- McGladrey – Law Firm Financial Report
- Mercer – Compensation Consulting Services
- Culpepper and Associates – Technology and Engineering
- Cruz Consulting Group – RIA Compensation

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## Subscription Databases

- Economic Research Institute - Salary Assessor and Executive Compensation Assessor
- Willis Towers Watson – Compensation Surveys
- Medical Group Management Association
- McGladrey – Law Firm Financial Report
- Mercer – Compensation Consulting Services
- Culpepper and Associates – Technology and Engineering
- Cruz Consulting Group – RIA Compensation
- RC Reports

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## Online Databases for Compensation Data

- Salary.com
- Indeed.com
- Payscale Salary Report
- SalaryGenius
- SimplyHired

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## Government Statistics

- U.S. Department of Labor – Career InfoNet
- [Employment Security Division – Washington State www.esd.wa.gov/employmentdata](http://www.esd.wa.gov/employmentdata)
- Bureau of Labor Statistics
  - Occupational Outlook
  - National Compensation Survey
  - Occupational Employment Statistics
  - Employment Cost Trends
  - Quarterly Census of Employment and Wages
  - Monthly Labor Review

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## Industry-Specific Compensation Reports

- CompAnalyst – Compensation Report
- Compensation Resources – Board of Directors Compensation Survey
- HedgeFundCompensationReport.com
- Heidrick & Struggles Private Equity Practice
- Holt Private Equity Consultants Compensation Report
- Preqin Private Capital Compensation and Employment Review
- Private Equity Professional - Carried Interest & Compensation
- Watson Wyatt Data Services – Survey Report on Board of Directors Compensation, Policies & Practices
- WorldatWork – Salary Budget Survey

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## Third Party Compensation Sources

- Compensation Experts
- Recruiters/Executive Search
- Vocational Experts
- Classified Ads

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# Reasonable Compensation Guidance



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## Tax Court Cases

- *Elliotts Inc. v. Commissioner*
- *LabelGraphics, Inc. v. Commissioner*—9th Circuit
- *Beiner, Inc. v. Commissioner*
- *E.J. Harrison and Sons, Inc. v. Commissioner*
- **Five Factors**
- *Mayson Mfg. Co. v. Commissioner*
- *B & D Foundations, Inc. v. Commissioner*—10th Circuit
- *Brewer Quality Homes, Inc. v. Commissioner*
- *Alpha Medical, Inc. v. Commissioner*
- **Nine Factors**
- *Pulsar Components, Inc. v. Commissioner*
- **Fourteen Factors**

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## Nine Factors

- The employee's qualifications
- The nature, extent, and scope of the employee's work
- The size and complexity of the business
- A comparison of salaries paid with the gross income and the net income
- The prevailing general economic conditions
- Comparison of salaries with distribution for stockholders
- The prevailing rates of compensation for comparable positions in comparable concerns
- The salary policy of the taxpayer as to all employees
- In the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employees in previous years

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## Five Additional Factors

- The amount of compensation paid to the particular employee in previous years
- Whether the employer and employee deal at arm's length
- Whether the employee guaranteed the employer's debt
- Whether the employer offers pensions or profit-sharing plans to its employees
- Whether the employee was reimbursed for expenses that the employee paid personally

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## Five Additional *Additional* Factors

- The employee's role in the company (position, duties performed, hours worked)
- The character and condition of the company
- Compensation levels for comparable positions in similarly situated companies
- The salary policy of the company
- The independent investor standard

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## The Independent Investor Test

The Tax Court initially noted that reasonable compensation would be determined under the independent investor test (see analysis of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 [7th Cir. 1999]), which states “if a hypothetical independent investor would consider the rate of return on his investment in the taxpayer corporation ‘a far higher return than . . . [he] had any reason to expect,’ the compensation paid to the corporation’s CEO is presumptively reasonable.”

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## Menard Inc. v. Commissioner

The Tax Court noted that *Exacto Spring* did not address the situation before it, i.e., “Where the investors’ rate of return on their investment generated by the taxpayer corporation, a closely held corporation, is sufficient to create a rebuttable presumption that the compensation paid to the corporation’s CEO is reasonable, but the compensation paid by the taxpayer corporation to its CEO substantially exceeded the compensation paid by comparable publicly traded corporations to their CEOs,” so it looked to § 162 for guidance. It concluded, “As we read section 1.162-7, Income Tax Regs., we are required to consider evidence of compensation paid to CEOs in comparable companies when such evidence is introduced to show the reasonableness or unreasonableness of a CEO’s compensation.”


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## IRS Reasonable Compensation Job Aid

- Dated October 29, 2014.
- Developed by a team of IRS Valuation Professionals from the Large Business and International Division (\$10mm+ in total assets)
- Designed for internal use by IRS Valuation Professionals on the Reasonable Compensation issue in Not-for-Profit and For-Profit entities.
- Consists of six sections and nine appendices.

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## Available Approaches

### Market Approach – Most Commonly Used Method

- The determination of the reasonableness of an employee's compensation is made by comparing the employee's compensation with the compensation of employees performing similar duties at similar companies.
- Sources of information used for the market compensation comparison were discussed previously – Benchmarking Surveys, Subscription Databases, Proxy Statements, Government Statistics (US BLS)
- Important Considerations:
  - \* What is included in the compensation data? (Retirement benefits, health insurance, stock options, perquisites, etc.)
  - \* How does the data define job titles, and are the duties/hours worked comparable?   \* How reliable are the statistics and sources used by the survey/database?

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## Available Approaches

### Cost Approach – Least Used Method

- The Cost Approach breaks down the duties of the employee into its components such as: company administration, accounting, finance, marketing, advertising, engineering, purchasing, etc.
- It takes into account all tasks performed and amount of time devoted to each.
- Comparability data is then used to determine the “cost” of each job duty performed by the employee.
- These are added up to arrive at a total “cost” to replace the duties/services of the employee.
- The weakness of the cost approach is that an employee might perform many different tasks to some degree, as is often the case with small business owners.

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## Available Approaches

### Income Approach – Independent Investor Test

- Creates a **rebuttable presumption** that an employee's compensation is reasonable if investors obtain a far higher return than they had any reason to expect. Rebuttable presumption is defined as *"a particular rule of law that may be inferred from the existence of a given set of facts and this is conclusive absent contrary evidence."*
- The rationale behind the Independent Investor Test is that investors pay employees to work to increase the value of the assets entrusted to their management. A high rate of return indicates that the asset's value increased and that the employee provided valuable services. Thus, if investors obtain returns above what they should reasonably expect, an employee's salary is presumptively reasonable.

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## Available Approaches

### Income Approach – Independent Investor Test

- IRS Reasonable Compensation Job Aid states, *"the presumption is rebutted if the high rate of return is attributable to an extraneous event rather than the manager's efforts."*
- "The income approach can only be correctly applied when the Fair Market Value of the company is available for each year that compensation is being examined. The FMV of a business entity often changes from year to year and can be a time consuming challenge to determine for any single year. As a result, the market approach is generally more useful than the income approach in a reasonable compensation analysis."
- Compares the total return to the required rate of return. Requires at least two valuations (beginning market value of equity and ending market value of equity)

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# Are BV Professionals Qualified to Opine on Reasonable Compensation?



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## Valuators or Compensation Experts or Both?

Many business valuation engagements require an assessment of reasonable compensation:

- When is it advisable for a valuation expert to perform a reasonable compensation analysis?
- When is it advisable to bring in a more focused compensation expert?
- When does it make sense to use both?

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## Situations where it makes sense to perform own compensation analysis

- When job title has a plethora of compensation data points
  - Examples: doctors, dentists, retail workers
- When the compensation adjustment is not material to outcome
- When the compensation adjustment is not controversial

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## Situations where it might make sense to hire a compensation expert

- When job title is unique
  - Examples: private equity, venture capital
- When the compensation adjustment is material or perceived to be material
- When the compensation adjustment is controversial
- When the compensation adjustment may be used in a 280G analysis for an acquisition

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## Do Reasonable Compensation Adjustments Result in a “Double Dip”?



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### What is “Double Dipping”?

- “Double Dipping” is the concept that the same income stream is being counted twice.
  - Once as an asset in the division of property – this occurs when compensation is adjusted in a business valuation
  - And again in the determination of spousal support

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## Double Dipping: Personal Goodwill

- The issue of double dipping is even more significant in jurisdictions where personal goodwill is considered marital property.
- "There are two categories of goodwill—enterprise and personal. Enterprise goodwill is that which exists independently of an individual's personal efforts and will outlast the individual's involvement with the business. In contrast, personal goodwill is that which is attributable to an individual's personal efforts and will cease when the individual's involvement with the business ends." *In re Marriage of Preston*, 2018 IL App (2d) 170656-U, ¶¶ 76-79 (Appellate Ct. of Ill. 2018)

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## Double Dipping: Personal Goodwill (cont.)

- Personal goodwill (also called professional goodwill) is a function of future earning power resulting from an individual's professional reputation, personal relationships with customers or suppliers, technical expertise, etc. It stems from continuing patronage to a business related to a particular person or people.
- If this goodwill value is fully reflected in the business valuation, then this future earning power is potentially being counted twice – once in property division and again in alimony.

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## Double Dipping Applied to a Business Valuation

When a business is valued using capitalization of earnings or a discounted cash flow, and the owner's compensation is adjusted, it is double dipping to both distribute the value of the business based on adjusted compensation and then to base spousal support on the income the owner actually receives from the business.

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## Double Dipping Cases: Know the law!

- Grunfeld v. Grunfeld – New York case indicating error to base both practice value and spousal maintenance on the same income stream.
- However, often, the "double dip" does not apply to child support: *Holterman v. Holterman*, New York; *Lutz v. Lutz*, Georgia; *Champion v. Champion*, Massachusetts.
- Loutts v. Loutts – Michigan case that went to appeal on a "double dip" argument but trial court had "discretion".
- Marriage of Huff – Colorado case where "double dip" was allowed.
- In re Marriage of Cheng – Washington State case where "double dip" was allowed.

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**Thank you!**

