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Fool on the Hill ... How to Avoid Reasonable Compensation Mistakes



Presented by:

Ronald Seigneur, CPA/ABV, ASA, CVA
Kevin Yeanoplos, CPA/ABV, ASA

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What is Reasonable Compensation?

Originates from IRC §162(a):

“In general

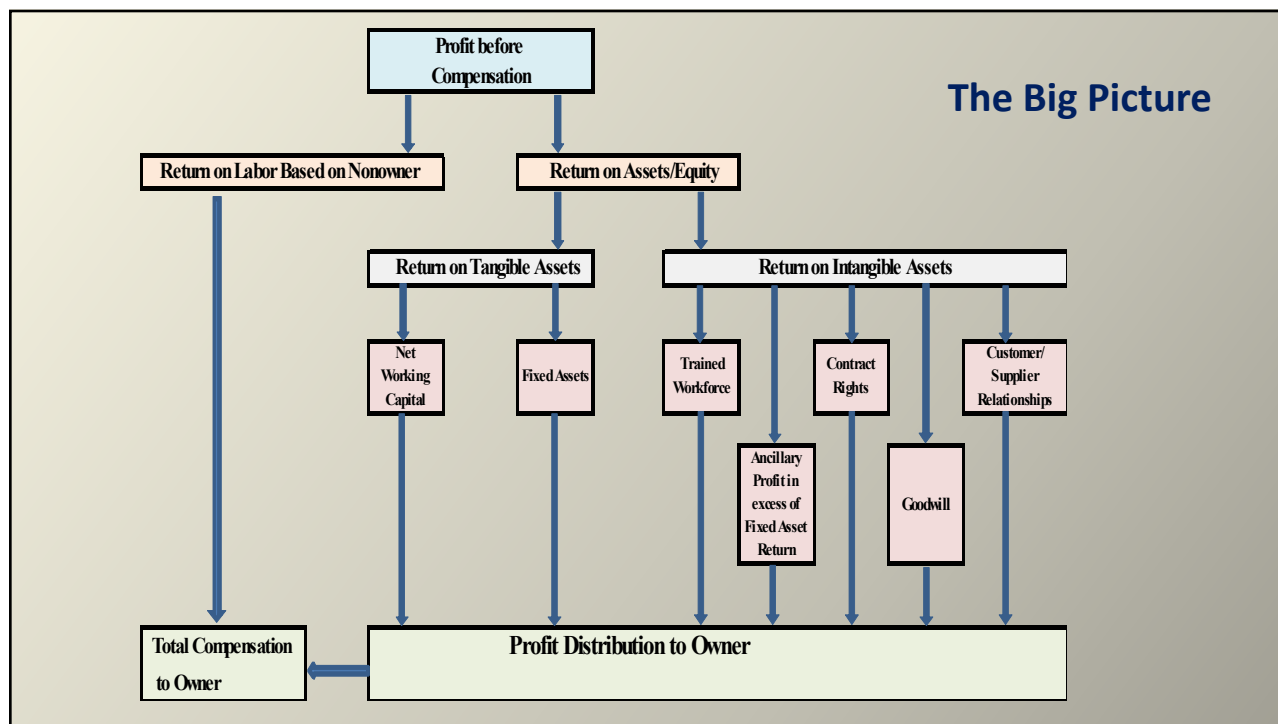
There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including –

- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered”

Treas. Reg. §1.162-7(b)(3) further states:

“In any event the allowance for the compensation paid may not exceed what is reasonable under all circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.”

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Two Competing Standards in Tax Court

Multi Factor Test:

- Guidance that can be used as an analytical framework for compensation for small to mid range businesses with active owner-employees.
 - Type and extent of services provided
 - Qualifications, training, and experience
 - Ownership related contributions to company
 - Company earnings and economic standing
 - Comparable compensation to others
 - Unique traits of company

Independent Investor Test:

- Guidance the owner/employee's compensation if reasonable if the business owners are receiving returns on their investments that are deemed acceptable.

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Court Cases – Multi Factor

***Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir.1949)**

Identified the following factors that should be considered with respect to the reasonableness of shareholder/executive compensation:

1. the employee's qualifications;
2. the nature, extent, and scope of the employee's work;
3. the size and complexities of the business;
4. a comparison of salaries paid with the gross income and the net income;
5. the prevailing general economic conditions;
6. comparison of salaries paid with distributions made to stockholders;
7. the prevailing rates of compensation for comparable positions in comparable concerns;
8. the salary policy of the taxpayer as to all employees;
9. in the case of small corporations with a limited number of officers, the amount compensation paid to the particular employee in previous years; and
10. the existence of the employee's agreement not to compete.

See *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987)

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Court Cases – Multi Factor

***Elliott's Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983)**

Set forth a frequently cited standard to determine the reasonableness of compensation for owners of closely held businesses:

1. The owners' qualifications and role in the corporation
2. The corporation's character and condition
3. Compensation levels for comparable positions in similar companies
4. The corporation's salary policy
5. The Independent Investor Standard

Remains the leading authority in the Ninth Circuit

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Court Cases – Multi Factor

***Pulsar Components, Inc. v. Commissioner*, T.C. Memo 1996-129**

Tax Court set forth an extensive list of factors to consider:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the employer's business
4. A comparison of salaries paid with the employer's gross and net income
5. The prevailing general economic conditions
6. A comparison of salaries with distributions to officers and retained earnings
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the employer as to all employees
9. The amount of compensation paid to the particular employee in previous years
10. The employer's financial condition
11. Whether the employer and employee deal at arm's length
12. Whether the employee guaranteed the employer's debt
13. Whether the employer offers pension or profit-sharing plans to its employees
14. Whether the employee was reimbursed for expenses that the employee paid personally

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In Summary: A Short List of Attributes that Should be Considered

- Duties and responsibilities
- Educational requirements
- Work history
- Deferred compensation elements
- Knowledge and relationships
- Time and effort - productivity
- Depth and abilities of others
- Determine salary for highest level of that person's duties
- Industry status and trends
- Location
- Company characteristics – size, competitive standing, operating results, and history
- Compensation at similar companies

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Court Cases – Independent Investor Test

***Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999)**

Seventh Circuit strongly rejected the Court's seven factor approach, stating:

"The Judges of the Tax Court are not equipped by training or by experience to determine the salaries of corporate officers; no Judges are."

Rather,

"The federal courts of appeals ... have been moving toward a much simpler and more purposive test, the 'independent investor' test ... we applaud the trend and join it."

IRS expert determined an investor in Exacto would expect a 13% return on their investment. The court noted that Exacto had a 20% return on investment. As such, the Seventh Circuit reversed the Tax Court's decision and rendered judgement in favor of the taxpayer, stating:

"presumably ... [reasonable investors] would be overjoyed to receive a return more than 50 percent greater than they expected."

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Court Cases

Multi Factor Test

Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949)
Elliott's Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983)
Brewer Quality Homes, Inc. v. Commissioner, T.C. Memo 2003-200
LabelGraphics, Inc. v. CIR, 221 F.3d 1091 (9th Cir. 1998)
Pulsar Components, T.C. Memo 1996-129
Haffner's Service Station v. Commissioner, 326 F.3d 1 (1st Cir. 2003)
Vitamin Village, Inc. v. Commissioner, T.C. Memo. 2007-272

Independent Investor Test

- *Estate of Wallace v. Commissioner*, 965 F.2d 1038 (11th Cir. 1992)
- *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999)
- *Midwest Eye Center*, T.C. Memo 2015-53
- *Aries Communications*, T.C. Memo 2013-97
- *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner*, T.C. Memo. 2011-74 (2011)
- *Owensby & Kritikos, Inc., v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987)
- *Home Interiors & Gifts, Inc. v. Commissioner*, 73 T.C. 1142, 1162 (1980)
- *B&D Foundation, Inc.*, TC CCH 54,505(M)(2001)
- *Guy Schoenecker, Inc. v. Commissioner*, T.C. Memo. 1995-539

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Court Cases

Prior Years' Under-Compensation

Estate of Wallace v. Commissioner, 965 F.2d 1038 (11th Cir. 1992)
American Foundry v. Commissioner, 59 T.C. 231 (1972), aff'd in part and rev'd in part, 536 F.2d 289 (9th Cir. 1976), acq. 1974-2 C.B. 1
Perlmutter v. Commissioner, 44 T.C. 382 (1965), aff'd, 373 F.2d 45 (10th Cir. 1967)
 * *R.J. Kremer Co. v. Commissioner*, T.C. Memo. 1980-69
Dixo Co., Inc. v. Commissioner, T.C. Memo. 1968-133, acq. 1969 AOD LEXIS 337
Pacific Grains, Inc. v. Commissioner, T.C. Memo. 1967-7, aff'd, 399 F.2d 603 (9th Cir. 1968)
Nelson Brothers, Inc. v. Commissioner, T.C. Memo. 1992-726
Willmark Service System, Inc. v. Commissioner, T.C. Memo. 1965-294, aff'd, 368 F.2d 359 (2d Cir. 1966)

Multiple Jobs ("Many Hats")

- *Estate of Wallace v. Commissioner*, 965 F.2d 1038 (11th Cir. 1992)
- * *Dockery v. Commissioner*, T.C. Memo. 1982-509
- * *Richlands Medical Association v. Commissioner*, T.C. Memo. 1990-660, aff'd, 953 F.2d 639 (4th Cir. 1992)
- * *Ken Miller Supply v. Commissioner*, T.C. Memo. 1978-228
- * *C.A. White Trucking v. Commissioner*, T.C. Memo. 1977-6, aff'd, 601 F.2d 867 (5th Cir. 1979)
- * *Hendricks Furniture v. Commissioner*, T.C. Memo. 1988-133

*Court agreed with IRS position the compensation was unreasonable but disagreed on amount considered reasonable compensation for years at issue.

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Matrimonial Decisions

- Schiro v. Schiro, 706 N.W.2d 27 (Mich. 2005) – Seigneur & Yeanoplos, page 83
- In re Marriage of Porter, unpublished (Wash.App. 2007) – Seigneur & Yeanoplos, page 74
- In re Marriage of Moller, unpublished (Minn.App. 1999) – Seigneur & Yeanoplos, page 73
- Ackerman – Seigneur & Yeanoplos, page 61

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“Gotchas”

- Failing to adjust for productivity
- Failing to account for commingled profit
- Failing to account for implicit return on assets

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Failing to Adjust for Productivity

- Compare and adjust as needed based on:
 - Hours worked
 - Units produced
 - Percentage of collections
 - Duties performed

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Alternatives for Manager/Owner Compensation

- Use senior management (non-owner) adjusted for experience
- Determine reasonable compensation based on a percentage of billing rate
- Use non-partner professional compensation
 - Director
 - Non-equity partner
 - Non-owner physician

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Effective Use of Compensation Databases

**Mixing apples and oranges just makes for a
bunch of fruit salad....**

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What is Included in the Salary Survey Data?

- Base Salary....based on what??
- Bonuses??
- Commissions and Incentive Compensation??
- Benefits??
- Pension Plan Contributions??
- Profit sharing??

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How Reliable is the Survey? - A 12 Point Checklist

1. Is data collected on a **national or regional** basis?
2. Does the data include owner/employees where the amount of compensation reported may also include **business profits** as compensation (i.e., partners in professions and businesses)?
3. Concerning data from business and professional associations, **what are the sampling sizes** that relate to the subject valuation?
4. When **using SIC codes** in identifying comparables, how do the particular characteristics of the subject company compare with the broader range of companies covered by the SIC code?
5. How does the data **use/define the job titles**, and are the actual duties comparable to the duties/hours of the subject owner/employee?

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How Reliable is the Survey? - A 12 Point Checklist (Cont.)

6. How does the data survey reflect **averages? Medians? Quartiles?**
7. Does the survey fairly reflect compensation for people with particular **niches and sub-specialties**: i.e., matrimonial attorneys, forensic accountants, lobbyists, etc.?
8. Does the valuator need to include **multiple job titles** from the survey data to cover the owner/employee's duties?
9. What is the **reliability** of the statistics and sources that the survey uses?
10. Where applicable, are stock options, restricted stock, shadow stock compensation, as well as other **perks reflected in the data** survey, and comparable to owner/employee in question?
11. Were all companies in the database consistent in having/not having **retirement plans** separate from salary?
12. Is the owner a **"key person"** in the business or a top performer/sales generator?

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Case Study of an Analysis of Reasonable Compensation for Healthcare Employee/Owners

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Salient Facts

Dermatology practice in the Northeast

Services provided

Cosmetic

Medical

Surgical

Formed in 2003

Sole proprietorship

Two physicians (one owner), two physician assistant, two RNs, 10 other staff

Last five years' revenues ranged from \$2.4 - \$2.8 million

Last five years' "net income" \$460 - \$808 thousand

Median "comparable" compensation \$448 thousand

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Issues With Resources

Lack of Statistical Validity

- "Sampling" bias - not a random sample
 - Dominated by Hospital-employed physicians
 - Concentrated in a few states
 - Is not representative of what a physician can earn in any given locale

"Compensation" is not what you think it is, i.e., clinical compensation

- Includes call pay, medical directorships, research stipends, **profit**, kitchen sink

Healthcare valuation community uses extensively

- "Bad data is better than no data"
- "Everyone else is doing it"

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Summary

Generally, physician compensation surveys are a minor subset (~6%) of physicians in the US, and most survey participants are employed by hospitals, health systems and other large organizations.

The usual and customary use of the survey data to assess reasonable compensation includes profit distributions, call coverage payments and other forms of compensation often ***not present in the private practice of the marital litigant.***

The RBRVS affords attorneys and their valuation analysts a standardized tool for measuring local market-specific reasonable compensation.

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Terms/Acronyms We Will Use Today

MPFS – Medicare Physician Fee Schedule

RBRVS – Resource Based Relative Value Scale

RVU – Relative Value Unit

- A measure of work output, like an hour in a law firm
- Physician compensation and benefits - wRVU
- Physician practice expenses – peRVU
- Physician malpractice insurance – mpRVU

HCPCS – Healthcare Common Procedure Coding System

Conversion Factor (CF) – a dollar amount that values each RVU type

- Like a billing rate in a law firm

GPCI – Geographic Practice Cost Index (“gypsy”) – county-based adjustment by Medicare to reflect higher expenses – e.g., San Francisco, Manhattan

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The RBRVS Method as The Market Approach

Medicare Reimbursement: Resource Based Relative Value Scale (RBRVS)

- Each procedure paid under the Medicare Physician Fee Schedule (MPFS) has three values assigned to it based on relative value units (RVUs)
- **Work component (wRVU)** – value of the physician’s or provider’s services
- **Practice expense component (peRVU)** – value of the resources used in providing the services
- **Malpractice component (mpRVU)** – value of resources used for malpractice (with some nuance)
- RVUs by type (w, pe, and mp) are adjusted for geographic location by a **Geographic Practice Cost Index (GPCI)** (pronounced “gypsy”)
- Total GPCI-adjusted RVUs are multiplied by a conversion factor to calculate the amount of the reimbursement

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RVUs and Compensation – Multiplication and Algebra

The formula looks like this without the GPCI, where CF is the Conversion Factor:

- $(wRVU + peRVU + mRVU) = RVU \times CF = \$Fee.$
- Restating this formula using the distributive property of algebra results in an equivalent amount:
- $(wRVU) \times CF + (peRVU) \times CF + (mRVU) \times CF = \$Fee.$

The formula looks like this with the Geographic Cost Practice Index or GPCI

- $(wGPCI \times wRVU + peGPCI \times peRVU + mGPCI \times mRVU) = GPCI \text{ RVUs} \times CF = \Fee
- The GPCIs for wRVU and peRVU are not necessarily the same!

$$2 \text{ wRVU} + 1.5 \text{ peRVU} + .1 \text{ mpRVU} = 3.6 * \$36.0391 \text{ CF (2019)} = \$129.74 \text{ Fee}$$

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IRS Job Aid

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IRS Reasonable Compensation Job Aid

The for IRS Valuation Professionals dated October 29, 2014 ("Job Aid") was developed by a Team of IRS Valuation Professionals from the Large Business and International Division.

- The cover of the Job Aid contains the disclaimer that the document is not an official IRS position and should not be "used or cited as authority for setting any legal position".
- The Job Aid was designed for internal use by IRS engineers and examiners, but contains useful information for valuation analysts.

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IRS Reasonable Compensation Job Aid (Cont.)

The Job Aid consists of six sections as well as nine appendices:

- Section I: Purpose, Background and Case Coordination
- Section II: Identifying a Reasonable Compensation Issue
- Section III: Developing Reasonable Compensation Issues
- Section IV: Taxpayer Arguments for Reasonable Compensation Issues
- Section V: Consideration of Penalties
- Section VI: Focusing Specifically on Not-For-Profits

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IRS Reasonable Compensation Job Aid (Cont.)

- Appendix A: Suggested Readings on Reasonable Compensation
- Appendix B: Data Sources for Compensation Issues
- Appendix C: Information Document Requests
- Appendix D: Financial Analysis
- Appendix E: Market Approach
- Appendix F: Income Approach
- Appendix G: Court Cases Relating to Prior Years Under-Compensation
- Appendix H: Court Cases Relating to Multiple Jobs
- Appendix I: Example of A Not-For-Profit Analysis (University Sector)

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IRS Reasonable Compensation Job Aid (Cont.)

Section I of the Job Aid outlines the history of the reasonable compensation issue and identifies the “valuation methods used in determining” reasonable compensation. The methods are the same as those used in the valuation of a business: the cost approach, the income approach, and the market approach.

The Job Aid states that the Courts (Tax Courts) favor the market approach, which it describes as being based on “comparing the employee’s compensation with the compensation of employees performing similar duties and similar companies.”

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IRS Reasonable Compensation Job Aid (Cont.)

Section III of the Job Aid explores the three approaches to reasonable compensation and Appendices E and F illustrate the market and income approaches:

The **market approach** is based on a comparison of the employee to similarly situated employees at other companies or how much an unrelated third party would receive for performing similar duties.

The **income approach** section of the Job Aid discusses the **Independent Investor Test**, the required rate of return for the employer's business, and the return on equity.

The **cost approach** involves determining an employee's compensation by allocating reasonable compensation for the particular duties based on the time spent performing those duties. The difficulty noted is accurately determining where the employee spends his or her time.

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IRS Reasonable Compensation Job Aid (Cont.)

Section IV of the Job Aid states five reasons a taxpayer may use to support the level of compensation determined. These issues are identified earlier in the Job Aid as prior year under-compensation, employees who perform multiple duties, whether the Independent Investor Test was met, employee personal guarantees of enterprise debt, and whether the subject is a key person with special abilities and qualifications that support a greater level of compensation.

Section V of the Job Aid discusses tax related penalties associated with unreasonable compensation.

The final section of the Job Aid discusses applicable considerations for tax-exempt entities.

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