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Unreasonable Compensation

Determining the amount of "reasonable" compensation paid to the company owner(s) represents the biggest challenge to a business appraiser. The adjustment, when appropriate, can make a substantial difference in the value conclusion of the business interest being appraised.

Reasonable compensation is determined by comparing the compensation paid to an employee or owner with the value of the services he or she performs. There are a number of issues that influence the amount of compensation paid to an owner – income tax considerations are generally the most important. The IRS has certain rules and guidelines that it uses to determine if the amount paid to an owner/employee is unreasonable. The type of business entity impacts some of these considerations. For example, there are many court cases in which the IRS claims that high dollar salaries paid to an owner of a 'C' corporation are unreasonable and much of the funds classified as salary should in fact be dividends subject to being taxed twice. In 'S' corporations or other pass-through entities, the IRS often challenges amounts paid to the owner as salary as being unreasonably low since the earnings net of owner's salaries are passed through to the company owners and taxed to them personally without payment of payroll taxes.

Some appraisal assignments of true minority interests in business entities do not warrant adjustments to officer compensation because a minority shareholder typically cannot force a modification to the amount paid to the owners or require virtually any other change. For this reason, most business appraisers do not adjust owner's compensation when valuing a minority interest. However, there are some times when an adjustment to officer's compensation is warranted even when valuing a minority interest. Valuations for divorce are one possible exception depending on the facts and circumstances of the case. A good example of this exception are some of the "games" that are played during a divorce or in anticipation of a divorce. Another example is a suit for shareholder oppression or something related to it.

A number of years ago I was asked to appraise a 30% minority interest in a large professional corporation in which an uncle made an initial large capital contribution in return for the interest which provided the funds to establish the business. Over the years, the nephew/owner took a reasonable salary and paid uncle 30% of the profits of the business. After uncle died, nephew took a larger and larger salary and thus paid aunt a smaller and smaller amount for the 30% owned. She eventually sued claiming shareholder oppression. I valued the corporation after making a substantial adjustment to the owner's compensation which made a huge difference in the value of the interest.

There are many factors that can be considered when evaluating the amount paid to company owners as compensation to determine what is reasonable vs. unreasonable. One of the best sources of the factors to consider comes from tax court case dealing with reasonable compensation in an IRS tax case. In this opinion in the case *Mad Auto Wrecking Inc. v. Commissioner*, Judge Laro suggested the following factors:

- The employee's qualifications
- The nature, extent, and scope of the employee's work

- The size and complexities of the employer's business
- A comparison of salaries paid with the employer's gross and net income
- The prevailing general economic conditions
- A comparison of salaries with distributions to shareholders and retained earnings
- The salary policy of the employer as to all employees
- The amount of compensation paid to the particular employee in previous years
- The employer's financial condition
- Whether the employer and employee dealt at arm's length (not usually a factor for appraisers)
- Whether the employee guaranteed the employer's debt
- Whether the employer offered a pension plan or profit-sharing plant to its employees
- Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

Out of these factors, the most pertinent are how many hours a week the owner works in the business, how many and what positions the owner essentially holds and what he or she does for the business, how easy or hard would it be to replace the owner, and the amount that would have to be paid to hire a replacement for the owner with similar skills and experience. In most small businesses, the owner must also personally guarantee any bank debt. Also, historical payments to the owner must be considered. It is not uncommon for an owner to take minimal compensation for many years while the business is growing and developing and later on, once it has become successful, take larger salaries to make up for the early years.

As Judge Laro stated in his opinion as reported in the text *Understanding Business Valuation*, "The dynamic nature of business, the entrepreneurial spirit, and the dedication of purpose all play a role in the composition of reasonable compensation. We must not rigidly apply form over substance when we measure one's contribution to the success of his or her business."

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

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