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Compensation Cases Offer New Solution to Executive Pay Issue

Over the past several years, the amount of compensation paid to owner-executives has, in some instances, reached astronomical levels, causing the IRS to question the "reasonableness" of such amounts. Since compensation often encompasses not only salary, commissions, and incentives, but also company-paid insurance, automobiles, and other perks, the issue of what is reasonable becomes complicated and leaves much room for debate. Recent cases involving compensation show how a business enterprise valuation can support the amount paid to an owner or key executive.

In the case of Exacto Spring Corp. v. Commissioner of Revenue Service, the U.S. Tax Court agreed with the IRS that the amount of compensation paid to the principal owner and CEO of Exacto Spring Corp, was unreasonable; therefore, the Court denied a deduction for the amount. Attorneys at Reinhart, Boerner, Van Deuren, Norris, and Rieselbach, S.C. appealed the case to the Seventh Circuit Court of Appeals.

The IRS allows companies to deduct a reasonable amount for salaries and other compensation for services actually performed. The IRS does not allow a deduction for an amount which represents a return on assets, such as stock dividends. To avoid double taxation, an owner-executive may withdraw corporate income as deductible compensation instead of as a nondeductible dividend. High compensation paid to a key executive of a closely held company may cause the IRS to suspect the company of structuring its pay plan for tax benefits.

In the Exacto case, the Tax Court used a "multi-factor" test to measure the reasonableness of the compensation paid to Exacto's CEO. The test considered the following factors: the type and extent of services rendered by the executive; the scarcity of qualified employees; the qualifications and prior earning capacity of the executive; the contributions of the executive to the business venture; the net earnings of the employer; the prevailing compensation paid to employees with comparable jobs; and the particular characteristics of the employer's business.

A Better Test

In the Exacto decision, the Seventh Circuit called the "multi-factor" test "nondirective" and "unclear" since it gives no indication of how to weigh each factor. Chief Circuit Judge Richard A. Posner further said that the test, "invites the Tax Court to set itself up as a superpersonnel department for closely held corporations, a role

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unsuitable for courts." The Seventh Circuit chose to use Reinhart's suggestion of a more relevant method, an "independent investor" test to measure the reasonableness of compensation. By applying this test, the Courts decide whether a hypothetical investor would agree with the executive's salary.

The independent investor test focuses on return on equity to determine if compensation is reasonable. If the investor received an adequate return on equity, the amount of compensation would be considered reasonable. A high rate of return would indicate that the employee is so instrumental to the success of the company that a high salary is justifiable.

In the Exacto case, the Court applied the independent investor test and discovered that Exacto's rate of return was greater than 20% during each of the years in question. The rate of return was calculated by comparing Exacto's adjusted taxable income to total shareholder equity. The Court found 100% of the Exacto executive's compensation reasonable and deductible. In addition, the Court emphasized that the executive's salary had been approved by other owners of the company.

State Contests Compensation

While the Exacto case involved the IRS, there are cases where compensation can be an issue with the state taxing authority. In a recent engagement completed by Valuation Research Corporation, the state taxing authority had been opposed to compensation paid to the owners of a large, national franchise operation.

The owners had received salaries in excess of 75 million per year over a span of 10 years. The state taxing authority charged that the company reported little or no net income (depending on the year) for state tax purposes. Since it was a Sub S corporation and all income accrues to the owners, there were no federal tax issues.

Valuation Supports Compensation

We performed a business enterprise valuation covering the period in question, starting with the year the owners began managing the corporation. Our conclusions showed that the value of the company increased from millions of dollars to billions of dollars during this time frame. Since there was a sufficient return on investment, the high compensation was considered acceptable.

In this particular case, the company settled the issue with the state taxing authority, and the case never made it to court. The business enterprise valuation played an essential role in justifying the owners' compensation. If you would like more information regarding this type of valuation, contact your Valuation Research representative, or call Jeffrey Trader at (414) 221-6250. VR