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Expert Shares His Approach for Determining Reasonable Compensation

Determining reasonable owner compensation for business owners can be contentious in a business valuation. Attorneys and the IRS often bring in compensation consultants to help establish reasonable compensation.

Business Valuation Update asked Mark Lipis (Lipis Consulting), a compensation consultant and plan designer, to explain how he approaches reasonable compensation issues. Lipis was the expert the IRS retained to testify in *Aries Communications Inc. v. Commissioner* (2013 Tax Ct. Memo LEXIS 111) (available at *BVLaw*).

***BVU:* How do you approach comparable owner compensation?**

Mark Lipis: Compensation professionals begin by looking at what owners of comparable companies are earning because it is both sensible and judicious to benchmark for a test for reasonableness. We also try to understand what the drivers of compensation have been or were or ought to be; we try to put compensation in context. One context might be the size of the company measured by revenues—other times, by the assets, return on equity, or any one of a number of measures. Typically we use several. One of the fundamental contexts is size. Bigger companies pay more than smaller companies, in general, especially established companies.

***BVU:* What are the major problems you encounter when developing reasonable owner compensation?**

ML: I have three answers for that: Data, data, and data. Finding usable and relevant data is the biggest problem for everyone who tries to determine reasonable compensation.

For example, I dealt with an allegation of unreasonable compensation at a firm in the apparel industry. In Los Angeles, we have hundreds of small shops—between $1 million and several million dollars in revenues a year—that make apparel and woven goods. They're all privately held and tight-lipped. I knew I'd have a tough time finding compensation data for that industry. I could find data on manufacturing companies, but this person isn't bending steel.

***BVU:* So what do you do in that situation?**

ML: We try to find some data that are usable even if they're not perfect, perhaps coming at it from several directions. For example, in one of the cases I'm involved with, we were able to find some data from a trade group, which are not perfect but they are better than nothing. We were able to find some companies that are sort of in the same NAICS industry code that are publicly traded, so we looked at proxy data. And, because we need to look at the compensation in context, we found some general manufacturing surveys put out by a trade association in Southern California, and it has both a manufacturing cut of data and a private company cut of data. We performed three different analyses based on the best data we could find.

We often use other sources, but the problem we and other compensation experts have with them is that, no matter what you're looking for,

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somehow the source has "an answer." It's sometimes referred to as "the magical formula." It is very important to find out where the sources get their data and how they use their data, and if you use the data consider it in the context of the project you are working on.

As compensation experts, we know some data sources are more reliable than others. We look not only at the numbers, but also at the methodology used to determine them. For example, some surveys have very small participation rates, and others have no quality control; they use whatever numbers the participants submit. We are also inherently suspicious of self-reported data. Also, we will not use data if the methodology used to collect the information doesn't make sense or it has obvious flaws.

BVU: In your analysis in the *Aries* case, you presented an opinion on what constituted reasonable compensation for the owner/operator of the radio broadcast stations operated by Aries and its subsidiaries. Can you tell us more about the process you used?

ML: Yes. In the *Aries* case, we considered executive officer compensation and broadcaster gross income and profitability information from the National Association of Broadcasters (NAB) for the position of general manager. We also considered public company proxies as reported by the Kenexa.com database.

We made adjustments to the data because we needed to take into account bonuses and because the proxy data from Kenexa.com included compensation for several television and radio companies that were much larger than Aries when measured by revenues. We then used scattergrams and regression analysis to show the correlation between compensation and revenue, net income, and profit margin.

***BVU:* In the *Arie*s case, the IRS statistician made an issue of the regression analysis the company's expert performed. Can you elaborate on that?**

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ML: Regression analysis is one of the more common techniques used to come up with the mathematical relationship between compensation and revenues or other measures and is a very useful tool when used properly. In the *Aries* case, although the company's expert did a regression, when the quality of the regression was calculated, the R-squared was shockingly low. The court determined that the compensation "P" paid to "E," its employee and owner, was unreasonable and disallowed most of its deduction for the tax year ending Aug. 31, 2004.

***BVU:* What do you do when the owner wears many hats, such as accounting and marketing?**

ML: When determining reasonable compensation, the *Elliotts* case (*Elliotts, Inc. v. Commissioner,* 716 F.2d 1241 (9th Cir. 1983)) is often treated as the benchmark case. The case sets forth a five-factor analysis to help determine reasonable compensation for the owner/employees of small to midsize closely held firms (see sidebar).

Now, what I'm about to say doesn't always make me popular, but the fact is that, when you're an owner-entrepreneur of a small to medium-sized business, you generally do wear many hats. You're the chief of R&D. You're chief of quality control. You're chief of sales. You're chief of everything except—you often have an accountant or a CFO. So the fact that an owner wears many hats is not as distinguishing a characteristic as you may think it is. For example, a $25 million company will have specialists, but the owners typically are wearing many hats. If they're in manufacturing, they may not be running a machine, but they're often in the shop, and they're conferring, troubleshooting, and solving problems.

You have to look at the facts and circumstances. Here's an example: A business owner has two roles: CEO and CFO. The owner dies, and the spouse or child takes over the business. The first thing the new CEO does is hire a CFO. The argument could be made that, when the owner/CEO was alive, the business was not spending $150,000 a year on a CFO. But when the owner died and the spouse hired a CFO, the company began spending more money.

Five-Factor Analysis for Reasonable Compensation

Elliotts, Inc. v. Commissioner (1983) remains the go-to case in the 9th Circuit for the five-factor analysis used in determining reasonable compensation for the owner/employees of small to midsize closely held firms. The five factors are:

1. Employee's role in the tax-paying company and how important that role is to the company's success, considering his or her position, hours, and duties;
2. External comparison of the employee's salary with salaries paid by similar companies for similar services;
3. Character and condition of the company, such as the company's size (measured as sales, net income, or value), complexity, and general economic conditions;
4. Factors that may indicate a conflict of interest, such as any relationship between the company and its employee that would permit the company to disguise nondeductible distributions as deductible compensation; and
5. Internal consistency in a company's treatment of payments to employees. If annual bonuses are calculated after a review of the year's profits, it may be an internal inconsistency that indicates excessive compensation.

***Mark Lipis** has a BS from Wharton and an MBA from the University of Chicago. He started his consulting career with William M. Mercer, then a division of Marsh & McLennan, later worked at KPMG and spent five years at The Wyatt Co. (now known as Towers Watson). He has consulted as Lipis Consulting since 1992. He can be reached at 310-445-4393 or through his website at www.lipisconsulting.com.*

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