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Fair Compensation, Intangibles, and Value

James B. Lurie, CPA/ABV, CVA, CIRA
7812 Brookdale Dr., Raleigh, North Carolina 27616

Reasonableness of the compensation of owner-managers and their family members is a frequent issue in litigation. The cases fall into two general categories:

Consideration of whether amounts paid can be deducted for tax purposes rather than being classified as non-deductible dividends, where compensation is the key issue, and

Consideration of levels of compensation as elements of enterprise value, where compensation is an ancillary issue.

Two key texts offer complementary suggestions about appropriate levels of owner-manager compensation. Pratt, Reilly and Schweihs say:

> "The 'normal level' of compensation is generally considered to be the expense of employing a non-owner/employee to perform the owner/employee's services."

In his Fourth Edition of *Valuing a Business*, Pratt expands that concept with a focus on the tax issue:

> "In many cases, the management of the closely held business are also the owners. By taking income in the form of compensation for services rendered instead of in the form of dividends, owners of C corporations avoid a layer of income tax at the corporate level. A hypothetical buyer of the entire business would want to be able to separate the existing owner's take-home pay between the amount that the buyer would have to spend to pay a substitute employee to perform the same duties and the amount that is attributable to a return on the buyer's investment."

Section 162(a)1 of the Internal Revenue Code addresses the matter with great simplicity, leaving it to the Courts to expand and clarify:

> "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;"

Two recent Tax Court cases provide differing approaches to the reasonableness of compensation. A consideration of these cases from the viewpoint of value, rather than simply deductibility, provides insight into an approach to support the deductibility of compensation to certain owners in excess of the levels which might be attributable only to current services.

Pediatric Surgical Associates, P.C. v. Commissioner of Internal Revenue, T.C. Memo. 2001-81, April 2, 2001

The Petitioner in this case was the only pediatric surgical practice in Fort Worth, Texas. Founded in 1976, the corporation employed 4 shareholder physicians, 2 non-shareholder physicians, and from 12 to 14 additional personnel during the years in question. The practice operated from three offices. For the audit years (1994 and 1995), the shareholder salaries were $1.30 million in 1994 and $1.53 million in 1995. Individual compensation over the two years ranged from $348,000 to $453,000.

The Court was clear in its statement that the practice had built up a substantial base of intangible assets in its two decades in business: "It is unlikely that, by themselves, the balance-sheet assets account for $2 million in gross

receipts. In addition to the balance-sheet assets, however, petitioner had assets not shown on its balance sheets… both the shareholder and nonshareholder employment contracts, petitioner's arrangement with the hospital to provide on-call services in the hospital's emergency room, and the goodwill that petitioner undoubtedly built up during its almost 20 years of business in the Fort Worth area."

The IRS did not challenge these salaries by reference to the salaries that the corporation would have had to pay to similarly qualified non-shareholder physicians with both medical and administrative responsibilities. Instead, the focus of the approach was an allocation of expense to the income generated by the non-shareholder employees. The Court agreed that the deductible salaries for the shareholder physicians should not include profits generated by services performed by the non-shareholder physicians. The question was how to determine those profits. The Court ultimately decided upon a full allocation approach, treating all of the practice's non-salary expenses, including both the direct expenses of support for the non-shareholder physicians and an allocable share of the indirect expenses such as rent, depreciation, repairs and maintenance, telephone, and equipment leases, as deductible against revenues generated by the non-shareholding physicians.

The final IRS position going into the case was that the salary deductions exceeded reasonable levels by $140,776 in 1994 and by $19,450 in 1995. After allocating the additional overhead expenses to the non-shareholder revenues, the Court decided that the over-deduction was limited to $61,234 for 1994 and $9,037 in 1995.

If the approach taken in *Pediatric Surgical Associates* was expanded to all professional practices, it is likely that the concept of practice goodwill could disappear. It is a reasonable extension to say that if, a "reasonable allowance for salaries or other compensation for personal services actually rendered" was 100% of the net income attributable to the services provided by a particular shareholder-physician, in a large medical practice with no non-shareholder physicians, there would be no income which could support the construct of practice goodwill. However, in an established practice with a large number of shareholders and a good reputation, practice goodwill does exist, even in the absence of non-shareholder physicians. If one physician of such a group left, it might well be possible to replace him with an employee physician at a substantially lower cost without materially affecting the practice revenues. The IRS position conflicts directly with the normal analysis in an appraisal of a professional practice of determining the expected income of the shareholder physician based upon the alternative employee or comparable compensation approach. It also ignores the concept of return on intangible assets such as location, reputation, and workforce-in-place.

Wagner Construction, Inc. v. Commissioner of Internal Revenue, T. C. Memo. 2001-160, June 29, 2001

The Petitioner in this case was an established Minnesota construction company, incorporated in 1985 after operating as a partnership from 1974. The President of the corporation was one of the founding partners (with his father); the Vice President, the President's brother, had been working in the business since its founding. In addition to an established business in road construction, the corporation had logging operations, owned storage facilities, and operated sand and gravel pits. Both brothers worked exceptionally long hours and, between them, had all executive and management responsibilities for an enterprise whose sales had averaged $5.7 million for the five years ending with the two audit years (1995 and 1996).

The Petitioner had one expert and the IRS had two. For various reasons, the Court rejected all of the expert opinions in disallowing a substantial portion of the claimed deductions; instead citing an Eighth Circuit case which provided nine criteria for evaluating compensation. The criteria, virtually all aimed at current activity, were:

The employee's qualifications;
The nature, extent and scope of the employee's work;
The size and complexities of the business
The prevailing general economic conditions;
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 employee in previous years;
A comparison of salaries paid with the gross income and net income; and
A comparison of salaries with distributions to stockholders.

> The Court approved deductions for officer's salaries of $635,000 for each of the two years under review, roughly 11.15% of revenues. The total deductions taken during those two years for officers' compensation were $2,483,232, nearly twice the amount allowed.

Despite the difference in approach to compensation in *Wagner* from that in *Pediatric Surgical*, there is a similar disregard for the values generated by founding management. Wagner had been in business for over 20 years, had a stable workforce, and an outstanding reputation. In a valuation of the business, each of those elements would be considered a contributor to value. In an asset-based approach, they would have been valued as individual assets.

Consideration of the Court's conclusion from an income approach produces a confusing result, because after deducting the permitted salaries, the remaining return on equity was less than the pre-tax level accepted by the Court as the minimum which would be acceptable by an independent investor. This result suggests that there may have substantial under performing assets within the business, possibly in the form of investments accumulated after years of successful operation.

Following is a simulation of Wagner Construction's hypothetical reported operating results assuming that the company had, over time, paid (with accruals established for payments not made in cash) officers' salaries equal to the 11.15% of sales ultimately approved by the Court for 1995 and 1996. The simulation also assumes that the Company accrued specific bonuses (of $700,000, $300,000, and $450,000) in the years 1990 through 1992, when operating performance was outstanding. The return on equity, adjusting equity for the additional accruals, would probably have been sufficient to satisfy a Court that shareholders were receiving a reasonable return on their investment over time.