

Reasonableness of Executive Compensation Insights

ISSUES RELATED TO A REASONABLENESS OF
EXECUTIVE COMPENSATION ANALYSIS

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INTRODUCTION

There are a number of situations that require an independent analysis of the reasonableness of (1) executive compensation for a corporate entity or (2) practitioner compensation for a professional practice. These situations include: substantiation of reasonable business expense income tax deductions, compliance with good corporate governance practices, family law and marital dissolution disputes, private inurement considerations related to not-for-profit tax status entities, and transaction/business/professional practice valuation pro forma compensation adjustments.

This article will further explain these reasons to conduct an independent reasonableness of executive/professional practitioner compensation analysis. In addition, this article will discuss many of the typical factors that the independent analyst will consider in assessing the reasonableness of executive compensation for controversy, taxation, corporate planning, and corporate governance purposes.

SUBSTANTIATION OF
BUSINESS EXPENSE
INCOME TAX DEDUCTIONS

Internal Revenue Code Section 162(a)(1) allows a corporation to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." The Internal Revenue Service (the "Service") often challenges the employee/shareholder executive compensation deductions claimed by closely held, regular C-type corporations. In such corporate taxpayers, it is common for a few individuals to serve as both (1) controlling corporate shareholders and (2) key company employees.

The question that the Service examines is whether the corporation is paying excessive executive salaries in order to avoid paying shareholder distributions. Such shareholder distributions (typically in the form of dividends), would result in a personal income tax liability to the shareholder—without an offsetting income tax deduction to the close corporation.

Closely held corporations that anticipate Service inquiries related to employee/shareholder compensation often have reasonableness of executive compensation analyses completed

on a periodic basis. Accordingly, the taxpayer corporation already has independent analysis documentation in its files before the Service raises the issue of excessive employee/shareholder compensation levels during the corporation income tax audit.

CORPORATE GOVERNANCE PRACTICES

In order to document compliance with good corporate governance practices, a public company's board of directors or board compensation committee may engage an independent analyst to periodically conduct reasonableness of executive compensation studies. In recent months, the well publicized

excessive compensation of some public company corporate executives has, at a minimum, created a public perception of corporate greed. These apparently excessive executive compensation packages have attracted the scrutiny of both securities regulators and corporate shareholders.

The Sarbanes-Oxley Act of 2002 (the "Act") affects a number of public corporation executive officer and board of director compensation practices. In order to demonstrate compliance with the Act, many public

corporations have sought an independent opinion of the reasonableness of their executive compensation. Such independent opinions assist directors (particularly the independent directors) (1) to evaluate the reasonableness of the corporation's executive compensation levels practices versus regulatory requirements and (2) to gain or restore shareholder confidence in the public company's corporate governance procedures.

FAMILY LAW/MARITAL DISSOLUTIONS

When a spouse in a marital dissolution is an owner/operator of a closely held or family-owned corporation, there is often a controversy regarding what is a reasonable level of the spouse's executive compensation. Business owner parties to a marital dissolution may be motivated to manipulate their own compensation in order to minimize:

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1. the apparent amount of the assets in the marital estate and
2. the apparent amount of personal income available to pay spousal and/or child support.

Accordingly, family law attorneys often retain independent analysts to conduct a reasonableness of employee/shareholder compensation analysis when either (1) employee/shareholder compensation is a separate marital dissolution issue or (2) the normalized level of employee/shareholder compensation is a controversial issue in the valuation of the family owned business.

NOT-FOR-PROFIT ORGANIZATIONS AND PRIVATE INUREMENT CONSIDERATIONS

Tax-exempt organizations, as defined in Internal Revenue Code Section 501(c)(3), are prohibited from making any actions that result in private inurement of the organization's assets. One aspect of private inurement involves paying excess compensation or other benefits to private individuals.

Internal Revenue Code Section 4958 defines an excess benefit transaction as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."

Prohibited transactions for not-for-profit tax-exempt organizations are defined in Internal Revenue Code Section 503. Such prohibited transactions include the payment of employee compensation "in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered."

For taxable organizations, reasonable compensation is defined as "such amount as would ordinarily be paid for like services by like enterprises under like circumstances." This definition is provided in Section 1.162-7 (b)(3) of the Treasury Regulations.

Accordingly, not-for-profit organizations often retain an independent analyst to conduct a reasonableness of executive compensation analysis related to their highly compensated officers. The purpose of these reasonableness of compensation analyses is to document compliance with the private inurement prohibitions of the Internal Revenue Code.

TRANSACTION/BUSINESS/PROFESSIONAL PRACTICE VALUATION ADJUSTMENTS

Some business owners pay themselves (and members of their family) minimal salaries as compensation to operate the family-owned business. This compensation practice has the effects of:

- (1) increasing the earnings of the business and (2) (possibly) increasing the attractiveness of the family-owned business to a potential acquirer.

The objective of the analyst when performing a business valuation for a potential transaction is to determine the business purchase price that reflects economic reality. As a standard business valuation procedure, the analyst may make adjustments to the historical and projected income statements if the actual compensation of the employee/shareholder does not reflect a level that is reasonable.

FACTORS TO BE CONSIDERED IN AN EXECUTIVE COMPENSATION ANALYSIS

In order to determine if an individual employee's compensation is reasonable, all of the facts and circumstances of the particular employee/employer and employer industry should be considered.

In *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949), the Court of Appeals identified nine factors that should be considered with respect to reasonableness of employee compensation. These nine factors are:

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 with distributions 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; and
9. in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.

REASONABLENESS OF EXECUTIVE COMPENSATION ANALYSIS

A reasonableness of executive compensation analysis often includes three principal categories of procedures.

First, the analyst compares the total level of executive compensation of the subject company to published executive compensation surveys (1) for the applicable industry and (2) for the applicable years.

Second, the analyst calculates a number of historical financial ratios related to the subject company results of operations including:

1. total officers' compensation to sales and
2. total officers' compensation to profit before interest and taxes.

Then, the analyst compares these subject company financial ratios to published industry benchmark financial ratios.

Third, the analyst performs a fair return on invested capital analysis. The objective of this type of analysis is to estimate the maximum amount of officer compensation that would allow the subject company shareholders to still earn a fair rate of return on the value of their investment.

Each of these three categories of reasonableness of executive compensation analyses will be summarized below.

INDUSTRY SALARY SURVEY ANALYSIS

An important factor for the analyst to consider in determining the reasonableness of executive compensation is the prevailing rates of compensation paid for comparable positions in comparable companies.

One executive position may be considered comparable to another executive position if the nature and scope of the duties performed in both positions are comparable. Additionally, the qualifications necessary to perform these duties should be similar.

Comparable companies (1) are generally in the same industry or line of business and (2) are of similar size, usually measured in terms of total assets or annual revenues.

INDUSTRY FINANCIAL RATIO ANALYSIS

In performing this category of analysis the analyst will typically calculate total officers' compensation (1) as a percent of sales and (2) as a percent of profit before interest and taxes. The calculated financial ratios for the subject company are then compared to published industry-specific benchmark financial ratios.

RESIDUAL FROM A FAIR RETURN ON INVESTED CAPITAL ANALYSIS

Analysts may also assess the reasonableness of executive compensation by calculating the residual economic income of the subject company. The "residual economic income" of a company is calculated after allowing for a fair rate of return on the fair market value of the stockholders' invested capital.

The stockholders are the owners of a corporation. Clearly, the stockholders want to receive a fair rate of return on the fair market value of their investment in the corporation.

Therefore, for a business to be considered successful from an investment perspective, it should earn a level of economic

income adequate to pay both (1) a reasonable level of compensation to the corporate executives (i.e., the managers of the business) and (2) a fair return to the corporate stockholders (i.e., the owners of the business).

If a business earns a level of economic income that exceeds that amount necessary to compensate both managers and owners, then the business is a successful investment. In economic terms, the business is earning excess economic income. In such a case,

1. the stockholders are fairly compensated for the value of their invested capital in the business,
2. the managers are fairly compensated for the value of their labor contribution to the business, and,
3. there is excess economic income available to distribute.

In a residual from a fair return on invested capital analysis, all of the excess economic income is allocated to management in order to assess the reasonableness of executive compensation. Since the company owners are fairly compensated for their investment and since management created the excess economic income as a result of their managerial skills, then (for purposes of this analysis) the stockholders should be willing to allocate all of the excess economic income to the managers.

Published decisions in recent court cases have emphasized the "independent investor test." If independent investors—or independent owners—would be satisfied with the return on their investment earned by the company (in the form of dividends and/or increased equity value), then the total compensation paid to the executive officers is reasonable. Absent evidence to the contrary, the analyst may conclude that the subject company's higher-than-expected returns are due to the superior efforts of those executives.

SUMMARY AND CONCLUSION

The issue of the reasonableness of executive compensation is important to: (1) closely held or family-owned corporations with controlling shareholders who are also key company employees, (2) public company boards of directors and board compensation committees, (3) family law attorneys, (4) directors of not-for-profit organizations, and (5) merger/acquisition and other valuation analysts.

In the last year or so, a microscope has been placed on public corporations by securities regulators and corporate shareholders. This public and private scrutiny has increased the importance of—and the awareness of—reasonableness of executive compensation economic analysis services.

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