ESOP Financial Advisor Insights

Assessing the Reasonableness of Retained Owner/Manager Compensation in ESOP Stock Purchase Analyses

Pamela J. Garland and Ashley L. Reilly

Introduction

The reasonableness of executive compensation is an important issue in many ESOP acquisition transactions. This is particularly the case when (1) the ESOP acquires a noncontrolling interest in the stock of the sponsor company and (2) the selling stockholders are retained to manage the sponsor company.

Prior to the ESOP transaction, the private company owners/managers may pay themselves at whatever compensation levels they want. Frequently, private company owner/managers pay themselves total compensation equal to virtually all of the company profits. This owner/manager compensation is paid through some combination of base salary and periodic bonus payments.

After the ESOP stock purchase transaction, however, the retained private company owner/managers cannot continue to pay themselves all of the profits as compensation. This is because some of the sponsor company profits must be used to amortize the ESOP acquisition debt.

And, some of the sponsor company profits must be either (1) retained in the company or (2) paid out to all shareholders (including the ESOP shareholders). It is through both (1) capital appreciation (from retained earnings) and (2) current income (from dividend distributions) that the ESOP earns a fair rate of return on its equity investment.

ESOPs and Reasonableness of Retained Owner/Manager Compensation

Accordingly, ESOP financial advisors and ESOP trustees must ensure that the retained (non-ESOP) private company owner/managers do not pay themselves more than a reasonable amount of executive compensation. The ESOP trustee is concerned that the retained owner/managers do not pay themselves unreasonable compensation amounts to the detriment of the ESOP stockholders. The ESOP lender is concerned that the retained owner/managers do not pay themselves unreasonable compensation amounts that jeopardize the sponsor company's ability to comfortably repay the ESOP acquisition debt.

This is why ESOP financial advisors, trustees, and lenders are all interested in determining what is a reasonable amount of executive compensation for the retained (non-ESOP) sponsor company owner/managers.

Determining the appropriate compensation structure for the retained owner/managers is often an important topic in the ESOP pricing, structuring, and financing negotiations. In addition, determining the appropriate process or protocol for the periodic setting/adjusting of the retained (non-ESOP) owner/manager compensation is an important negotiation topic in many ESOP formations.

"This is why ESOP financial advisors, trustees, and lenders are all interested in determining what is a reasonable amount of executive compensation for the retained (non-ESOP) sponsor company owner/managers."

This article will discuss the procedures commonly used by financial advisors in determining the reasonableness of closely held company owner/manager executive compensation.

These procedures are particularly relevant in situations where:

1. the ESOP acquires less than operational/ownership control of the sponsor corporation,
2. the selling shareholders retain operational/ownership control of the sponsor corporation, and
3. the selling shareholders are retained to manage the company on a going-forward basis.

Reasonableness of Retained Owner/Manager Compensation Factors

When deciding the reasonableness of retained owner/manager compensation in a closely held corporation, ESOP financial advisors often seek professional guidance from (1) Internal Revenue Service ("Service") publications and guidelines and (2) judicial precedent regarding the tax deductibility of close corporation owner/manager compensation payments.

There are several factors that the courts have considered to assess the reasonableness of close corporation shareholder/employee executive compensation. All of these factors effectively ask the question: if the closely held company was hiring a nonshareholder employee, how much compensation would be paid in an arm's-length employee negotiation?

Nine factors that courts often consider regarding the reasonableness of shareholder/employee compensation are delineated in a 50-plus-year-old judicial decision, *Mayson Manufacturing Company*, 178 F.2d 115 (6th Cir. 1949). The *Mayson Manufacturing Company* case is particularly relevant to ESOP financial advisors. This is because the reasonableness of compensation factors delineated in this case are almost identical to the factors specified by the Service in its audit manual (see *Internal Revenue Manual* Section 4.35.2.5.2.2 (3/1/02)).

The *Mayson Manufacturing Company* case outlined the following nine factors with regard to the reasonableness of shareholder/employee compensation:

1. the employee's particular qualifications for the job;
2. the nature, scope, and extent of the work actually performed by the employee;
3. the size and complexity of the particular business enterprise;
4. a comparison of salaries paid with the gross income and the net income;
5. the economic conditions and background of the industry involved;
6. the particular company's dividend history;
7. comparable salaries in the industry;
8. the compensation paid to the company's other employees; and
9. the employee's prior years' compensation (especially for years in which the subject employee was clearly undercompensated).

"The Mayson Manufacturing Company *case outlined the following nine factors with regard to the reasonableness of shareholder/employee compensation. . . ."*

According to *Henry Shotmeyer*, T.C. Memo 1980-238 (July 8, 1980), the reasonableness of compensation test is a cumulative one, focusing on all years in which the employee rendered services to the corporation. And, according to *Elliots, Inc.*, 716 F.2d 1241 (9th Cir. 1983), the above-mentioned *Mayson* factors should each be researched and analyzed, without giving undue weight to any one of the nine factors.

The following case review illustrates the application of the *Mayson* factors to a recent (2003) judicial decision. The issue in this particular case was the income tax deduction of shareholder/employee compensation in a regular C corporation. However, the court's application of the nine *Mayson* factors should be informative to ESOP financial advisors considering the reasonableness of retained owner/manager compensation after an ESOP acquisition.

Recent Application of the *Mayson* Factors in the *Haffner's Service Station* Case[1]

Haffner's Service Station ("Haffner's") was a closely held C corporation with three officers: (1) Haff, the president, (2) his father, Emile, and (3) his mother, Louise. During the years 1990 to 1992, Emile and Louise were paid 2.3 million dollars in bonuses by Haffner's. Upon audit, the Service claimed that (1) these bonuses represented unreasonably high executive compensation and, therefore, (2) these bonuses were not deductible to the C corporation.

At the trial court level, the Tax Court agreed with the Service regarding the disguised dividend nature of the parents' compensation. In this 2003 Appeals Court decision, the First Circuit affirmed the Tax Court's ruling.

In deciding whether shareholder/employee compensation is unreasonable for income tax purposes, federal courts often use either (1) a single-factor independent investor test or (2) a multifactor test.

Using a single-factor independent investor test, the court asks whether an independent investor would be satisfied with the implied rate of return implicit on the hypothetical investor's investment in the subject corporation. This implied rate of return is calculated based on the company's taxable income—that is, a level of income after deducting the expense of the potentially excessive executive compensation.

The Appeals Court used a multifactor reasonableness of shareholder/employee compensation test in the *Haffner's Service Stations* case. The First Circuit enumerated the following ten factors that it considered to determine the reasonableness of the subject C corporation shareholder/employee compensation:

"The Appeals Court used a multifactor reasonableness of shareholder/employee compensation compensation test in the Haffner's Service Stations *case."*

1. The employee's qualifications—In the subject case, neither Emile nor Louise had extensive skills.
2. The nature, extent, and scope of the actual work—In the subject case, the Appeals Court concluded that the parents' work was nonessential.
3. The size and complexity of the subject business—In the subject case, the Appeals Court concluded that the Haffner's business was neither complex nor large.
4. Comparison of the executive compensation paid with the company's gross income (versus taxable income)—In the subject case, the percentage of Haffner's gross income represented by the subject executive compensation was very high.

5. The general economic conditions—In the subject case, there were no unusually adverse economic conditions to overcome during the 1990 to 1993 period; therefore, the Appeals Court concluded that Emile and Louise did not cause the company's financial success.
6. Comparison of salaries paid (a) to shareholder distributions and (b) to retained earnings—There were no dividends paid to the shareholders in the Haffner's case. And, the Appeals Court did not determine if the shareholders had received a reasonable rate of return on their investment in the Haffner's stock.
7. Prevailing rates of compensation for comparable positions in comparable companies—There was no information presented to the Appeals Court by either litigant to determine this factor in the Haffner's case.
8. The company's salary policy for other (nonshareholder) employees—No other nonshareholder employee was paid a six-figure level of compensation at Haffner's.
9. Whether the compensation paid to shareholder/employees in prior years was deficient—In the years at question, Emile and Louise needed money to finance a family lawsuit; the Appeals Court concluded that they had not been under-compensated in any prior years (i.e., the 1990 to 1992 payments did not represent "catch-up" compensation for prior year deficiencies).
10. Absence of a pension/profit sharing plan—There was no documented pension or profit sharing plan for any of the employees at Haffner's.

> *"The ESOP financial advisor is concerned with the reasonableness of Smith's executive compensation on a post-ESOP, going-forward basis."*

Illustrative Reasonableness of Shareholder/Employee Compensation Analysis

Acme Widget Corporation ("Acme") is considering an ESOP formation. The two company founders/stockholders, Harry Smith and Ben Jones, are considering the sale of 30 percent of the Acme common stock to an ESOP. Smith and Jones will continue to own the remainder of the outstanding Acme common stock.

Smith and Jones will be retained as owner/managers of Acme. The ESOP financial advisor is concerned with the reasonableness of Smith's executive compensation on a post-ESOP, going-forward basis.

This Acme "mini case study" illustrates the quantitative components of a typical reasonableness of executive compensation study. In a comprehensive reasonableness of compensation analysis, both the quantitative and the qualitative *Mayson* factors would be considered. This example—and the associated analyses—are deliberately simplified and are presented for illustrative purposes only.

Acme manufactures and distributes widgets. Acme is a regular C corporation for federal income tax purposes. Harry Smith serves as both (1) the president/chief executive officer and (2) the chief marketing officer of the corporation.

Smith is (and will continue to be) a principal stockholder of Acme. Pre-ESOP, Smith and Jones own 80 percent and 20 percent of the Acme common stock, respectively. Post-ESOP, Smith and Jones will own 56 percent and 14 percent of the Acme common stock, respectively. Post-ESOP, the ESOP will own the remaining 30 percent of the Acme common stock.

For the 2005 year (i.e., after the sale of stock to the ESOP), Acme is projected to generate revenue of $10 million. Also, for the 2005 year, the average assets of Acme are projected to be $2 million. For the 2005 year, Acme will pay Smith $1.2 million in executive compensation.

Both pre-ESOP and post-ESOP, Smith is the controlling shareholder. Smith sets Jones' compensation, presumably on an arm's-length basis. Therefore, the ESOP financial advisor is not particularly concerned with the issue of Jones' compensation. However, Smith also sets his own compensation. Accordingly, the ESOP financial advisor (and the trustee) are interested in assessing: is this level of owner/manager compensation reasonable for Smith?

Exhibit 1 summarizes a simplified salary survey analysis. Such an analysis looks to published executive compensation survey data. Such data are typically presented (1) by size of company and (2) by industry.

In this particular example, the financial advisor considered four different executive salary surveys:

1. the Economic Research Institute (ERI) Executive Compensation Assessor as of July 1, 2004;
2. the Watson Wyatt Data Services 2004/2005 Top Management Comp Calculator;
3. *Compensation in Manufacturing*, 24th edition, 2004, by Abbott, Langer & Associates, Inc.; and
4. *Widget Weekly* 2004 Salary Survey, published by the American Widget Association.

Exhibit 1 presents a range of the maximum reasonable compensation levels for executives performing comparable duties to Smith at comparable companies. Based on the various published salary survey analyses summarized in Exhibit 1, the indicated range of maximum reasonable executive compensation for Smith is $850,000 to $1,292,000.

Exhibit 2 summarizes a simplified financial ratio analysis. Exhibit 2 presents the total reasonable executive compensation

Exhibit 1
Acme Widget Corporation
Reasonableness of Owner/Manager Executive Compensation
Salary Survey Analysis

	ERI Executive Compensation Assessor [a]		
	Median $	75th Percentile $	90th Percentile $
1	229,000	281,000	460,000
2	205,000	280,000	390,000
	434,000	561,000	850,000

	Watson Wyatt Comp Calculator [b]		
	Median $	75th Percentile $	90th Percentile $
1	307,600	469,100	820,000
2	215,600	255,800	472,000
	523,200	724,900	1,292,000

	Abbott Langer *Compensation in Manufacturing* [c]	
	Median $	90th Percentile $
1	300,000	607,000
2	200,500	413,700
	500,500	1,020,700

	Widget Weekly Salary Survey [d]	
	Median $	75th Percentile $
1	330,000	520,000
2	244,000	330,000
	574,000	850,000

Indicated Range of Maximum Reasonable Executive Compensation Levels: $850,000 to $1,292,000

Notes:
[a] Line 1: Widget manufacturing, revenue between $10 and $15 million, chief executive officer position.
Line 2: Widget manufacturing, revenue between $10 and $15 million, chief marketing officer position.
[b] Line 1: Widget manufacturing, sales of $10 million, chief executive officer position.
Line 2: Widget manufacturing, sales of $10 million, chief marketing officer position.
[c] Line 1: Widget manufacturing, revenue between $10 and $15 million, chief executive officer position.
Line 2: Widget manufacturing, revenue between $10 and $15 million, chief marketing officer position.
[d] Line 1: Widget manufacturing, revenue of $10 million, chief executive officer position.
Line 2: Widget manufacturing, revenue of $10 million, chief marketing officer position.

Exhibit 2
Acme Widget Corporation
Reasonableness of Owner/Manager Executive Compensation
Financial Ratio Analyses

Total Officers' Compensation as a % of Revenue

Almanac of Business & Industrial Ratios [a]	
Industry Code	Mean Percent
123456	18.7%

RMA Annual Statement Studies [a]		
Industry Code	Median Percent	75th Percentile
123456	25.7%	31.0%

Range of Reasonable Executive Compensation Levels
For All Officers as a Group

	Industry Financial Ratio Observations		
Total Officers' Compensation—as a % of Revenue	18.7%	25.7%	31.0%
Multiplied by: Acme Widget Corporation Annual Revenue	$10,000,000	$10,000,000	$10,000,000
Equals: Reasonable Total Officers' Compensation Levels	$1,870,000	$2,570,000	$3,100,000

Indicated Range of Maximum Reasonable Executive Compensation Levels [b]	$1,870,000	to	$3,100,000
Less: Officer Compensation Paid to Ben Jones	800,000		800,000
Equals: Residual Indicated Range of Maximum Reasonable Executive Compensation for Harry Smith	$1,070,000	to	$2,500,000

Notes:
[a] Widget manufacturing companies, asset size from $1 to $5 million.
[b] For all (i.e., both) corporate officers of Acme Widget Corporation.

Exhibit 3
Acme Widget Corporation
Reasonableness of Owner/Manager Executive Compensation
The Independent Investor Test
Fair Return on Equity Capital Analysis

	Actual 2001 $	Actual 2002 $	Actual 2003 $	Actual 2004 $	Projected 2005 $
Total Revenue	8,000,000	8,600,000	9,000,000	9,500,000	10,000,000
Total Expenses [a]	4,200,000	5,000,000	5,050,000	5,000,000	7,100,000
Pretax Net Income	4,500,000	4,500,000	4,450,000	4,500,000	2,900,000
Fair Return on Equity Capital Analysis:					
Estimated Value of Owners' Equity Capital	9,000,000	9,500,000	10,000,000	10,500,000	11,000,000
Multiplied by: Pretax Expected Fair Rate of Return on Owners' Equity Capital [b]					8%
Equals: Fair Return on Value of Owners' Equity Capital					880,000
Residual Reasonableness of Executive Compensation Analysis:					
Projected 2005 Pretax Net Income (Including all Projected ESOP Expense)					2,900,000
Maximum Reasonable Total Officers' Executive Compensation [c]					2,020,000
Less: Officer Compensation Paid to Ben Jones					800,000
Equals: Residual Maximum Reasonable Executive Compensation for Harry Smith					1,220,000

Notes:
[a] Including operating expense, interest expense, all ESOP-related expense for 2005, but before officers' compensation expense.
[b] The total expected rate of return on owners' equity capital includes two components: (1) current income (or dividend yield) rate of return and (2) long-term capital appreciation (or capital gain yield) rate of return. The indicated 8% expected rate of return in this simplified example represents only the current income component of the total expected rate of return on owners' capital.
[c] Pretax net income for 2005 ($2,900,000) less fair return on the value of owners' equity capital ($880,000) equals $2,020,000.

Exhibit 4
Acme Widget Corporation
Reasonableness of Owner/Manager Executive Compensation
Post-ESOP Stock Purchase Transaction
Summary and Conclusion

Exhibit Reference	Owner/Manager Executive Compensation Analysis	Indicated Range of Maximum Reasonable Compensation
1	Salary Survey Analysis	$850,000 to $1,292,000
2	Financial Ratio Analysis	$1,070,000 to $2,500,000
3	Independent Investor Test	$1,220,000
Harry Smith Projected Post-ESOP 2005 Executive Compensation		$1,200,000
Is Harry Smith's Projected Post-ESOP 2005 Executive Compensation Reasonable?		Yes

levels for all of the corporate officers (as a group) of Acme Widget Corporation.

Exhibit 2 reports illustrative industry financial ratio data from two commonly referenced annual publications: the *Almanac of Business and Financial Ratios* and the *Risk Management Association Annual Statement Studies*. Exhibit 2 presents data from the 2004 editions of these publications—i.e., the most recent empirical data available at the time of the ESOP financial advisor's analysis.

The particular financial ratio analysis presented on Exhibit 2 considers the executive compensation levels for all company officers as a group. Therefore, it is noteworthy that Acme has two corporate officers: (1) Harry Smith (who will be paid $1.2 million in 2005) and (2) Ben Jones, vice president, chief financial officer, and secretary (who will be paid $800,000 in 2005). Therefore, in 2005, total officer compensation for Acme will be $2.0 million.

"The independent investor test is based on a fair rate of return on capital (typically, equity capital) analysis."

After subtracting the Ben Jones $800,000 compensation, the Exhibit 2 financial ratio analysis presents a residual range of the maximum reasonable executive compensation for Harry Smith. Based on the various financial ratio analyses summarized in Exhibit 2, the indicated range of maximum reasonable executive compensation for Smith is $1,070,000 to $2,500,000.

Exhibit 3 summarizes a simplified independent investor test with regard to the reasonableness of Smith's executive compensation. The independent investor test is a single factor test that has been widely accepted by the courts in recent years.

"The reasonableness of retained owner/manager executive compensation is an important issue in ESOP stock purchase negotiations and pricing decisions."

The independent investor test is based on a fair rate of return on capital (typically, equity capital) analysis. Exhibit 3 presents (1) an estimated value for the Acme total owners' equity during 2005 (presumably, that estimated value should be equal to the ESOP stock purchase transaction valuation) and (2) a hypothetical independent investor's expected fair rate of return on the owners' equity capital.

Subtracting (1) the independent investor's expected fair return on owners' equity capital from (2) the company's pretax net income indicates (3) a reasonable level of executive compensation available for the subject company total officer group.

After subtracting the Ben Jones $800,000 compensation, the Exhibit 3 independent investor test analysis presents a residual range of the maximum reasonable executive compensation for Harry Smith. Based on the independent investor test summarized in Exhibit 3, the indicated maximum reasonable executive compensation for Smith is $1,220,000.

Exhibit 4 summarizes the conclusions from the three reasonableness of executive compensation analyses presented in this Acme Widget Corporation mini case study.

Based on the reasonableness of executive compensation analyses illustrated in Exhibits 1, 2, and 3, and summarized in Exhibit 4, the Harry Smith projected $1.2 million executive compensation for 2005, is not unreasonable.

Of course, this example—and the corresponding analyses—are deliberately simplified. And, only the quantitative reasonableness of compensation analyses are illustrated in this example.

In an actual reasonableness of compensation analysis, both qualitative and quantitative analyses would be considered. Nonetheless, the ESOP financial advisor (and the ESOP trustee) may conclude that it is not unreasonable to use Smith's projected $1.2 million compensation expense (1) in the ESOP stock valuation and (2) in the ESOP pricing/structuring negotiations.

Summary and Conclusion

The reasonableness of retained owner/manager executive compensation is an important issue in ESOP stock purchase negotiations and pricing decisions. This is particularly true when the (non-ESOP) selling shareholders (1) will retain ownership/operational control of the sponsor company and (2) will be retained to manage the sponsor company.

In such cases, the ESOP financial advisor (and the ESOP trustee) should assess the reasonableness of the retained owner/managers compensation with regard to both (1) stock valuation/pricing and (2) stock purchase/investment decisions.

This article reviewed the factors that the courts and the Service routinely consider in assessing the reasonableness of shareholder/employee executive compensation for federal income tax purposes. These factors should provide professional guidance to financial advisors in assessing the reasonableness of retained owner/manager compensation for ESOP formation and stock valuation purposes.

Notes:

1. *Spicer Accounting, Inc.* v. *Commissioner*, 918 F.2d 90 (9th Cir. 1990).

Pamela J. Garland is a senior manager in our Chicago office. She can be reached at (773) 399-4323 or pgarland@willamette.com. Ashley L. Reilly is an intern in our Chicago office. Ashley can be reached at (773) 399-4324 or alreilly@willamette.com.