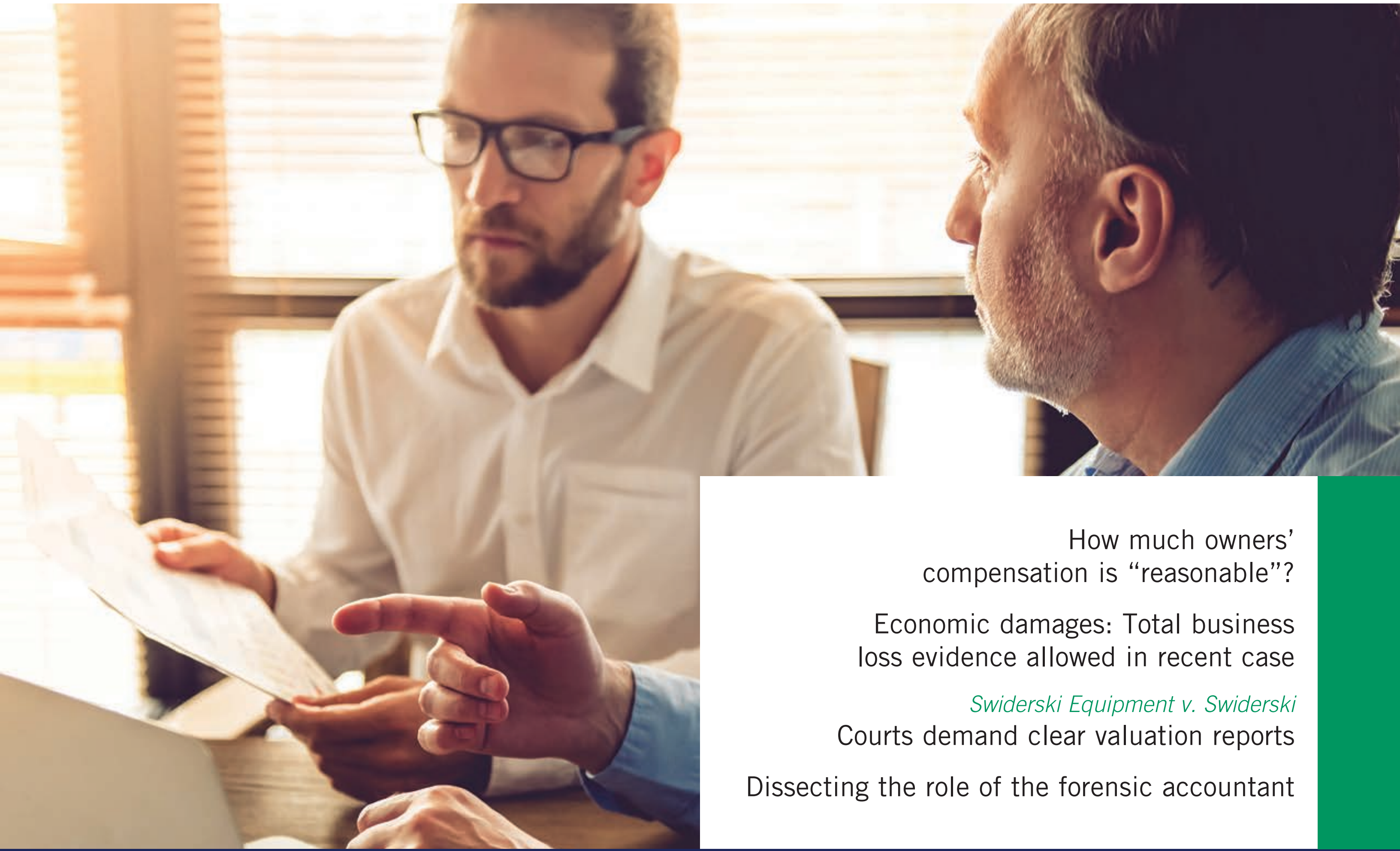
JULY / AUGUST 2018

ADVOCATE'S EDGE



How much owners' compensation is "reasonable"?

The IRS may challenge the amount of compensation a business pays to its owners and other related parties under a variety of situations. Knowing the factors the U.S. Tax Court will weigh when evaluating compensation for reasonableness can help your clients come out on top.

Framing the issue

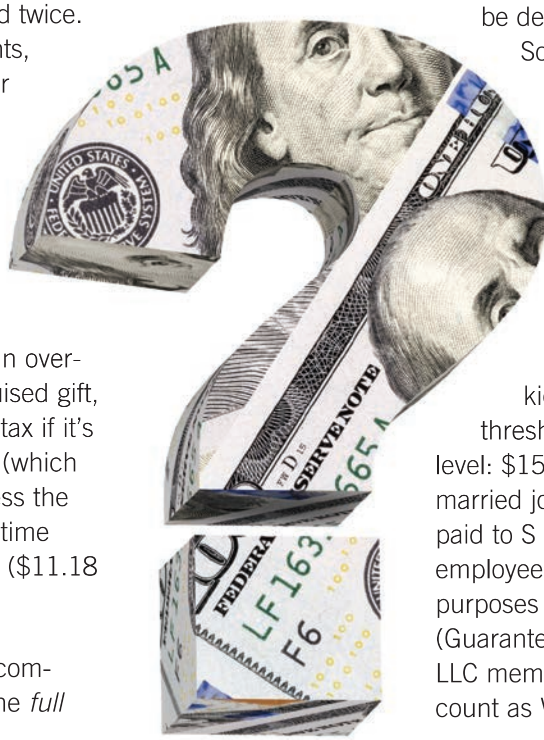
Internal Revenue Code Section 162 allows the deduction of ordinary and necessary business expenses, including reasonable compensation. Sec. 162 defines reasonable compensation as the amount that would ordinarily be paid for like services by like organizations in like circumstances.

Sometimes, the IRS claims that a C corporation has overpaid an individual and reclassifies excessive payments as disguised:

Dividends. Dividends are taxed twice. Unlike compensation payments, dividends aren't deductible for federal income tax purposes. So, the corporation pays income tax on the earnings. Then, the recipient pays personal-level tax on the dividend income.

Gifts. The IRS may say that an overpaid relative received a disguised gift, which may be subject to gift tax if it's above the annual exemption (which is $15,000 for 2018) — unless the donor taps into his or her lifetime estate and gift tax exemption ($11.18 million for 2018).

When assessing reasonable compensation, the IRS looks at the *full* compensation package, including W-2 wages and other perks. Loans the business makes to owners and other related parties at no or low interest could represent another form of compensation.



When it might be understated

Sometimes, S corporations may try to *underpay* shareholder-employees to avoid federal and state payroll taxes. Then the company makes up for the below-market salary by making cash distributions to the owner(s) that aren't subject to payroll taxes.

The Tax Cuts and Jobs Act could provide an extra incentive to underpay owners of pass-through entities: the deduction for up to 20% of qualified business income (QBI). Reasonable compensation paid to owners of a qualified business (including guaranteed payments to partners and LLC members treated as partners for tax purposes) must be deducted when computing QBI. So, the lower the compensation deductions, the higher the QBI deduction for qualified businesses.

However, the QBI deduction is also limited to 50% of the W-2 wages paid by a qualified business. This limitation doesn't kick in until a taxable income threshold is reached at the owner level: $157,500, or $315,000 for a married joint-filer. Reasonable salaries paid to S corporation shareholder-employees count as W-2 wages for purposes of computing this limitation. (Guaranteed payments to partners and LLC members treated as partners don't count as W-2 wages.)

For example, suppose a single-owner S corporation has QBI of $1 million after deducting $250,000 of owners' compensation and $300,000 of W-2 wages paid to nonowner employees. Its QBI deduction would be $200,000. This equals the lesser of 1) $200,000 (20% of $1 million), or 2) $275,000 (50% of $550,000 of W-2 wages).

Conversely, if the owner of this hypothetical S corporation increased her salary to $500,000, her QBI would be $750,000. So, the QBI deduction would be only $150,000. This equals the lesser of 1) $150,000 (20% of $750,000), or 2) $400,000 (50% of $800,000).

To complicate matters even further, QBI deductions are limited for certain types of service businesses, such as medical practices and law firms, when an owner's taxable income exceeds the applicable threshold.

IRS guide offers reasonable compensation insights

The IRS guide *Reasonable Compensation: Job Aid for IRS Valuation Professionals* provides insight into what IRS agents consider when deciding whether compensation paid by a C corporation to a shareholder-employee seems "reasonable." Relevant considerations include:

- The company's process for setting compensation,
- Tax return data, including compensation not reported on a Form W-2,
- The number of employees at issue,
- External salary surveys,
- Compensation data from comparable companies (for example, ratio of overall owners' compensation compared to comparable company sales),
- A taxable income comparison, such as how the compensation affects the company's taxable income, and
- Ratios of owners' compensation to median employee compensation.

The job aid lists three general valuation approaches used to determine reasonable compensation: cost, income and market approaches. It emphasizes how objective market data (the market approach) can be used to estimate reasonable compensation. However, the cost and income approaches, along with financial analysis, can also be used to refine the reasonable compensation amount.

Analyzing compensation

The U.S. Tax Court has historically favored a market approach that compares an owner's compensation to what employees are paid for performing similar duties at similar companies. Other issues the court considers when estimating reasonable compensation include the following:

- What duties does the individual perform, and how many hours does he or she work?
- Is the company large? Professionally managed? Profitable and growing?
- Was the compensation paid under a formal and consistently applied compensation program?
- Is there a conflict of interest between the company and the individual that could lead the company to label corporate payouts as deductible compensation?

Additionally, the Tax Court usually applies the "independent investor test." That is, if the company's return on equity after subtracting compensation payments would satisfy a hypothetical independent investor, the compensation is probably reasonable.

Need help?

In recent years, the IRS has given significant attention to whether owners of closely held businesses pay themselves too much or too little. The new QBI deduction could heighten that scrutiny. A financial expert can help your clients establish formal compensation programs, based on market-based pay rates. Doing so may help prevent IRS audits and support owners' compensation deductions if the IRS makes an inquiry. ■

Economic damages: Total business loss evidence allowed in recent case

The Eighth Circuit Court of Appeals recently issued a surprising decision: It allowed a qualified damages expert to present a conclusion for the loss of a company's *entire* value in a case where the plaintiff continued to operate after the defendants' alleged wrongdoing.

Mass exodus

In 2012, CT Freight's primary source of revenue was shipping dry agricultural commodities (a business known as the "bulk hopper" industry). In February 2013, ten employees resigned from the Nebraska company to join a start-up competing freight brokerage operation. The resigning employees brought several large accounts with them. CT Freight sued the start-up, its owner and the ten employees for, among other things, tortious interference with business relationships.

> The Eighth Circuit considered, among other issues, whether the district court had erred by allowing the jury to consider evidence of total loss of business value damages.

The plaintiff hired a valuation expert who compared the revenue generated by CT Freight's top 20 customers in 2012 and 2013 and found that revenue from the company's top customers effectively disappeared in March and April 2013. Then the expert analyzed the start-up's revenue from its top customers in 2013 and found that the start-up, which hadn't previously had many sales, realized significant revenue from CT Freight's former top customers.

Based on his review of the company's financial results for 2011 to 2014, the expert also found that CT Freight was unprofitable following the mass resignation through 2014. The expert concluded that the market value of CT Freight was $2,131,000 before the defendants resigned, based on "the value of future profits."

A jury found the defendants liable and awarded the plaintiff about $1.5 million, which is equivalent to approximately 70% of its value before the employees left. It's possible that the jury arrived at that amount because the top 20 customers generated about 70% to 75% of the company's revenue. The defendants appealed.

Disputed damages evidence

In lawsuits alleging injury to a business, plaintiffs generally may recover damages for either 1) the market value of the business if the business is completely destroyed, or 2) lost profits if the business isn't destroyed.

On appeal, the Eighth Circuit considered, among other issues, whether the district court had erred by allowing the jury to consider evidence of total loss of business value damages. This was particularly unusual, because CT Freight continued to operate after the alleged wrongdoing, although it had substantial difficulties replacing lost customers and employees who resigned and was forced to expand into new sectors.

As long as sufficient evidence of a loss of profits is presented, the court explained, Nebraska state law permits a jury to determine the probable loss from the best evidence "the nature of the case allows." In this case, the best evidence had been presented by an experienced CPA and valuation professional who found that, after the employees' resignation, CT Freight's business was effectively a total loss. The Eighth Circuit therefore affirmed the district court's ruling, holding that the district court hadn't erred in admitting the plaintiff's expert's testimony on the company's value.

Useful resource in deliberations

It's unusual for a court to allow a plaintiff in business litigation to be awarded a loss based on the value of the entire business — especially when the business continues to operate. But this evidence can, nonetheless, be helpful to a judge or jury when awarding economic damages. ■

Swiderski Equipment v. Swiderski

Courts demand clear valuation reports

Vague business valuation reports can be confusing and prolong commercial litigation. A stock redemption case that landed in a Wisconsin Court of Appeals illustrates these consequences.

Back to the drawing board

In January 2013, a family-owned farm equipment company decided to exercise its right to buy out the only minority shareholder's interest. Its corporate redemption agreement (CRA) gave the company the option to buy back the stock for a fixed price of $1,000 per share. The fixed price, which had been determined when the CRA was drafted in 1986, was subject to reappraisal under certain conditions.

The Circuit Court for Outagamie County, Wisconsin, ordered the minority shareholder to accept a payment of $510,000 for his 510 shares. On appeal, the minority shareholder argued that his interest was worth more than $1,000 per share. The appellate court remanded *Swiderski* to the circuit court, ruling that an appraisal was required under the CRA.

A business valuation expert concluded that the shares were worth $615,000 as of December 31, 2012. So, the circuit court ordered the company to pay an additional $105,000 for the minority interest. Again, the case was appealed.

Challenges to the valuation

This time, the minority shareholder challenged the business valuation on several grounds. Among other things, he argued that:

- The expert shouldn't have applied a minority interest discount, and
- The circuit court shouldn't have instructed the expert to presume, based on previous litigation, that compensation paid the owner of the company wasn't excessive.

The appeals court agreed that the expert shouldn't have applied the minority discount. It also found that the lower court's instruction regarding compensation would be moot if the expert had in fact performed an independent analysis of whether the owner's compensation was reasonable.

Unfortunately, the expert's valuation report didn't make clear whether the expert had applied a minority discount or conducted an independent compensation analysis. Although the report didn't discuss a specific minority discount, it stated that the value was "based on a minority cash flow." And, while the report suggested that the expert had analyzed the owner's compensation, it didn't include any details, such as the use of industry compensation ratios. Assessing whether valuation discounts apply and determining if owners' compensation appears reasonable are standard procedures when valuing a business.

Because the expert's report wasn't clear regarding these issues, the case was sent back to the circuit court for a new valuation.

Words matter

Swiderski demonstrates the potential consequences of ambiguously written reports. Comprehensive reports provide enough detail to help a judge or jury understand the expert's analyses and calculations, using precise language that leaves no room for question. ■

Dissecting the role of the forensic accountant

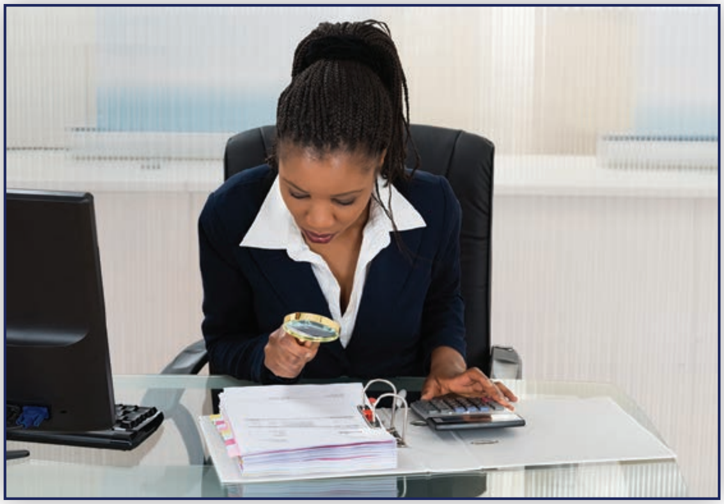
When people hear the term "forensic *science*," they usually think "CSI." What comes to mind when you hear the term "forensic *accounting*"? Accounting is a technical area of expertise — and, similar to forensic scientists offering opinions about scientific matters, forensic accountants may be called on to serve as expert witnesses in commercial litigation. Here's how these experts can help clients unearth hidden assets and liabilities, revenue and expenses — and even help solve crimes.

How forensic accountants can help

If a client suspects that someone is stealing business assets or misrepresenting a company's financial performance, it may be time to contact a forensic accountant. These experts specialize in conducting fraud audits and investigations to detect irregularities and troubling trends, looking for both telltale and subtle signs of white collar crime.

Certified fraud examiners (CFEs) are specially trained in fraud discovery, recognition, documentation and prevention. They are also generally knowledgeable about human behavioral factors and motivations that contribute to the commission of fraud, such as the ability to rationalize fraudulent conduct.

Often, forensic accountants are retained to detect misrepresentations of financial data or to locate missing funds. It's important to investigate fraud suspicions as early as possible to help mitigate potential losses.



What to expect

When you engage a forensic accountant, you can expect the expert to work closely with you and your client to tailor an investigation to the situation at hand. Depending on the type of fraud suspected, the investigation may be performed on a comprehensive, companywide or random, spot-check basis.

Forensic accountants will work to determine the scope of the fraud, including how long it has gone on and the parties involved. Investigations typically require extensive document review. In a case involving asset misappropriation, for example, experts might search for forged documents.

They also look for evidence of compliance — or noncompliance — with Generally Accepted Accounting Principles (GAAP). Of course, GAAP compliance doesn't guarantee legitimate accounting, so an investigation might also focus on specific areas that wouldn't necessarily be caught in an audit, such as the use of assets at the operational level. Are they being used as intended or for the benefit of an employee? Are all of the assets accounted for?

When working with a forensic accounting expert, beware of attorney-client privilege issues. Because accountants lack this protective privilege, they must work closely with you to determine their roles and they need to be cautious about whom they interview. If, for example, plaintiffs' attorneys become involved, these parties are likely to request any notes of interviews conducted by forensic experts.

When to expand the scope

Special investigations also can be effective in uncovering high-level financial fraud. A board usually receives its financial and operational information from a company's highest executives. Investigations provide a method for the board to obtain access to deeper, more detailed information without going through the executive level of management. Instead, investigators can gather information directly from those in the trenches, using methods such as interviews, and immerse themselves in data and information unfiltered by top management. They then are able to communicate directly with the board.

Fraud investigations can be particularly useful to monitor the activities of top executives — even if only for policy lapses. Upper-management employees often are given greater latitude and may be tempted to bend the rules. When this occurs, it can influence the ethical environment of an entire company and encourage other employees to disregard policies or even commit fraud.

When to call

As soon as the inkling of financial impropriety arises, consult a forensic accounting expert. His or her early involvement can help minimize fraud losses, preserve confidentiality and admissibility of evidence, and possibly even reduce your client's overall litigation costs. ■