



## Valuing the Closely Held Business

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By Johanne M. Floser

Aside from the many important and critical issues involving children and family, the valuation of a closely held business or professional practice may be one of the most significant issues a practitioner will face when resolving the financial aspects of matrimonial matters. In that regard, one of the most important aspects that the valuator is confronted with is the establishment of a reasonable level of replacement compensation to assign to the owner in the valuation of an ownership interest.

In order to do this properly, one must be aware of various concepts relating to replacement compensation, including: 1) what it is; 2) why it is important; 3) what issues must be identified and avoided; and 4) how replacement compensation is determined. Even though you may be counting on experts to value these assets, an understanding of what they are (or should be) considering in their thought processes is a valuable tool.

### What Is Replacement Compensation?

Many closely held businesses and professional practices distribute most, if not all, of their earnings to the owner(s) and do not make the distinction between what constitutes fair and reasonable compensation for services that the owner provides to the entity versus what constitutes a return on the ownership interest. It is, therefore, the job of the valuator to separate the earnings stream into those two components.

An owner's compensation may consist of many segments. The most obvious elements are the base salary, bonus, dividends and/or withdrawals that the business pays to its owner. There are also other discretionary items that are many times commonplace in closely held businesses and professional practices and may, in fact, be considered compensation. The valuation process not only involves identifying the obvious elements of the earnings stream, but also includes an analysis that goes beyond the numbers as reported to determine if there are any perquisites, personal expenses or other items. These may be disguised in such business expense categories as entertainment and automobile expenses that are reported on the subject entity's books but are, in essence, part of the "compensation package." An owner's perquisites may also include retirement plans, life insurance, disability insurance, health club memberships, country club dues and other similar items that are provided to the owner as a greater benefit or to the exclusion of other non-owner employees of the business. Entertainment expenses may be, in reality, an owner's perquisite if the expense is not a reasonable and ordinary business-related expenditure as compared with industry norms. Likewise, automobile expenses, including those related to automobile leases, insurance, repairs and gasoline, may also be considered additional owner's compensation if such expenses are not specifically related to business operations.

Another, less recognized area where replacement compensation should be considered is compensation paid to related parties (*i.e.*, family members). It is certainly not improper to include a family member on the company's payroll as long as the compensation is reasonable and the services for which payment is made are actually performed. In such instances, however, it may be necessary to substitute the compensation that is actually paid to the family member with a provision for replacement compensation at a level that would ordinarily be paid in the marketplace to a non-related individual who would perform similar duties.

### Why Is Replacement Compensation Important?

Considering that, in many cases, the adjustment for replacement compensation is one of the largest monetary adjustments made during the valuation of a small- to medium-sized operating entity, it should be undertaken with utmost care and consideration.

The theoretical underpinnings of valuing an ownership interest assume that there is some value attributable to the economic benefits afforded the owner (*i.e.*, the prerogatives of ownership including the power to determine management compensation and perquisites) that is not present in a mere employer/employee relationship. The excess of earnings over and above what the individual would earn *absent* the ownership interest, *i.e.*, replacement compensation as a non-owner, forms the basis for the goodwill connected to the ownership interest. Non-owner replacement compensation is, therefore, a critical component in a valuation. It is the job of the valuator to break down the net income into its two distinct components. The first component is the

compensation to the owner and related parties *without* regard to the prerogatives afforded to an ownership interest. The second component represents the remaining amount of income attributable to the ownership interest itself. By adding back the actual compensation paid to the owner and other related parties and subtracting a provision for non-owner or fair market replacement compensation from the earnings stream being capitalized, the valuator has essentially isolated or captured that portion of the earnings stream attributable to "ownership," which is the subject of valuation.

### Issues to Identify and Avoid

During the valuation process, the valuator must be careful to identify the components of compensation that will be replaced, and ascertain if the same elements are included in the level of replacement compensation being substituted. Failure to do so may create a double counting that could distort the earnings that are ultimately used as a basis for valuation. For example, some compensation surveys that are referenced as evidence of replacement compensation present their data as "total compensation," which, in some instances, includes base salary and perquisites. If the valuator does not include the owner's perquisites as an add-back to the earnings stream before subtracting a level of replacement compensation based on a "total compensation" that includes perquisites, he/she has misstated the normalized earnings stream that forms the basis for valuation. Depending on the level of perquisites that were ignored, the resulting aberrational value could be significantly higher or lower than it actually should be.

There are also other forms of double counting (duplication) that must be considered in the equitable distribution of an ownership interest *vis-à-vis* spousal maintenance in matrimonial proceedings. In its decision in *McSparron v. McSparron* (87 NY2d 275, 662 (1995)), the New York Court of Appeals referenced the license/ practice/maintenance overlap when it concluded that professional licenses may have an ongoing independent vitality and, as such, should be valued in a way that avoids duplicative awards. The court stated, "Care must be taken to ensure that the monetary value assigned to the license does not overlap with the value assigned to other marital assets that are derived from the license such as the licensed spouse's professional practice."

When both a professional practice and a professional degree or license are being valued, replacement compensation becomes a key factor in both valuations. In such instances, duplicative awards are avoided by utilizing the level of non-owner replacement compensation assigned in the practice valuation as the Top-Line Earnings (*i.e.*, the license holder's earnings capacity *with* the attainment) in the license computation.

In cases where a business or practice interest is valued without the valuation of a professional degree or license, it is also necessary to guard against potential duplication in the form of maintenance derived from earnings that are incorporated in the asset value, assuming equitable distribution of that asset. This is achieved by limiting the income available for maintenance to the level of non-owner replacement compensation assigned for the services rendered by the owner to the entity being valued. Since the income in excess of the replacement compensation is incorporated into the value of the asset, it is only the replacement compensation that is available for maintenance and child support.

The duplication concept, however, was most recently argued before the Court of Appeals in the case of *Keane v. Keane*, 8 NY3d 115 (Dec. 21, 2006). Also, in *Holterman v. Holterman* 3 NY2d 1 (Jun 10, 2004), a case in which this author's firm was retained as valuation experts, the Court of Appeals ruled on the issue of duplicative awards in the context of child support. In both instances, the court created a dangerous and troublesome precedent that could result in serious unintended consequences.

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**Johanne M. Floser** is a Certified Business Appraiser (CBA) and Manager with BST Valuation & Litigation Advisors, LLC, with offices in Albany, NY, and New York City. She has extensive experience in the valuation of privately held business enterprises, professional practices, professional licenses, advanced academic degrees and pension/retirement plans for use in matrimonial matters, litigation, buy/sell transactions, estate tax proceedings and other circumstances.



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### **Part Two of a Two-Part Article**

The assessment of replacement compensation generally includes a review of industry statistics and other pertinent factors, including the experience and judgment of the valuation expert. Before a level of replacement compensation can be determined, the valuator must consider numerous factors including, but not limited to, the types of duties that the owner performs in his/her position with the business, the owner's education and level of experience, and the number of hours the owner works in comparison to non-owner employees who perform similar duties and have a comparable educational and experience background as the owner. In addition, the size of the company, the complexity of its organizational structure and the geographical region of the country may impact the decision-making process relative to the level of replacement compensation to utilize.

In order for replacement compensation to have a true economic basis, it must be reasonable for the circumstances at hand. One of the most developed areas of the law involving replacement compensation issues evolved from tax court decisions that were argued for purposes of assessing the ordinary and necessary nature of the expense for executives and/or related parties. In addition, the tax courts have ruled, and have provided guidance, within the context of valuation for estate and gift tax purposes. As a result of the numerous tax court decisions that have been handed down on this subject area, it can be helpful to look to those court decisions for guidance in matrimonial cases.

#### ***Mad Auto Wrecking Inc. v. Commissioner***

In its decision in *Mad Auto Wrecking Inc. v. Commissioner* (T.C. Memo 1995-153, RIA T.C. Memo P.95153, 69 CCH TCM 2330), the court addressed several points that were considered and accepted in the determination of the level of compensation that should be afforded the two officers of Mad Auto Wrecking, an auto salvage business with gross revenues of approximately \$2 million. The court stated that "compensation must be both 1) reasonable; and 2) paid purely for services rendered to the corporation" in order for it to be deducted as "an ordinary and necessary business expense" under Section 162(a)(1) of the Internal Revenue Code. The court identified and discussed 14 factors that may be considered including: 1) the employee's qualifications; 2) the nature, extent, and scope of the employee's work; 3) the size and complexities of the employer's business; 4) a comparison of salaries paid with the employer's gross and net income; 5) the general economic conditions; 6) a comparison of salaries with distributions to shareholders and retained earnings; 7) the prevailing rates of compensation for comparable positions in comparable companies; 8) the employer's salary policy as to all employees; 9) the amount of compensation paid to the particular employee in previous years; 10) the employer's past and present financial condition; 11) whether the employer and employee dealt at arm's length; 12) whether the employee guaranteed any of the employer's debt; 13) whether the employer offered a pension plan or profit-sharing plan to its employees; and 14) whether the employee was reimbursed by the employer for business expenses that the employee paid personally.

#### ***Haffner's Service Station v. Commissioner***

Similarly, in *Haffner's Service Station v. Commissioner*, 326 F3d 1 (1<sup>st</sup> Cir. 2003), the court, citing *Mad Auto Wrecking, supra.*, identified the following 10 factors it considered in assessing the reasonableness of bonuses paid to two of its board members including the controlling shareholder/treasurer and her husband who was also the company's assistant treasurer and secretary: 1) the employee's qualifications; 2) the nature, extent, and scope of the employee's work; 3) the size and complexities of the employer's business; 4) a comparison of salaries paid with net and gross income; 5) the general economic conditions; 6) a comparison of salaries with distributions to shareholders and retained earnings; 7) the prevailing rates of compensation for comparable positions in comparable companies; 8) the employer's salary policy as to all employees; 9) the compensation paid in prior years; and 10) the absence of a pension plan/profit-sharing plan.

The *Haffner's* court also considered a then-more-recent Seventh Circuit Court of Appeals disagreement with the "multifactor test" in favor of an assessment of whether an independent investor would have approved the amount of compensation paid to its employee. In addition, the *Haffner's* court also observed, and ultimately adopted, the Second and Ninth Circuits' Courts of Appeal requirement that "the various factors of the traditional test be analyzed from the perspective of an independent investor."

## An Important Lesson

The *Haffner's* court decision provides an important lesson with regard to the sources and use of compensation data. After careful consideration of the testimony given by the witness that was called to testify on behalf of Haffner's and recognized by the court as an expert on reasonable compensation, the court ultimately rejected the reasonableness of the bonuses in question because the expert primarily relied on data received from a related and interested party, blindly relied on non-specific data compiled in an industry publication and compared Haffner's with four publicly traded companies that the court concluded were not actually comparable with Haffner's.

Accordingly, when it comes to using industry statistical data, it is imperative that the valuator exercise care and perform the necessary due diligence and avoid the blind use of those statistics that could be very misleading and produce a wrong result. Industry statistics are acceptable to use as a platform upon which to undertake a personalized analysis in arriving at the appropriate level of replacement compensation. The valuator must, however, read and understand the criteria under which the statistical sources are compiled and the foundational information contained in the study before a meaningful comparison can be made between the statistics and the subject individual.

## Data Sources

Nonetheless, a number of empirical sources for salary surveys are available for use in assessing reasonable replacement compensation for valuation purposes. Not surprising, some sources are better than others, so the valuation expert must use his or her expertise and judgment to determine the relevance and reliability of data. Trade associations may provide a wealth of knowledge for salary data by position or job title within a specific industry. Examples include Altman Weil's annual *Survey of Law Firm Economics* and *The Small Law Firm Economic Survey*, which publishes compensation data for lawyers; Medical Group Management Association's (MGMA's) *Physician Compensation and Production Survey*, which publishes compensation data for medical specialties; and other similar surveys for specific job titles in other industries.

More generally, there are surveys that publish salary data by position or job title that may not be industry-specific, but that are still a reliable resource. Examples include the National Institute of Business Management's *Annual Executive Compensation Survey Analysis* and Gale Research's *American Salaries and Wage Survey*. A myriad of compensation databases are also available. Costs for these databases run the gamut, from those that can be accessed for free on-line to others that are available by subscription only for a cost of several thousands of dollars.

Data may also be available through business journals, employment agencies and executive recruitment firms. Another possible resource, depending on the size of the subject company being valued, is the salary disclosure information reported in documents filed with the Securities and Exchange Commission (SEC) on behalf of publicly traded companies.

It is, however, generally better to use salary surveys that report data by individual position or job title rather than as a percentage of revenues or other financial indicia, as some financial publications do. While this information may be useful for assessing financial trends in a given industry, it may not provide enough supporting details to determine such things as the product mix or geographic marketplace served by the businesses in the survey or the components of compensation that are included in the reported data.

## *Douglas v. Douglas*

Replacement compensation can also be determined by an analysis of the compensation practices employed by the subject company for their non-owner employees. Such was the case in *Douglas v. Douglas*, 722 NYS2d 87 (2001), in which this author's firm was retained as valuation experts. Here, the Appellate Division, Third Department, affirmed the methodology used to assess reasonable compensation, stating, "Relying upon his previous experience in valuing the interests of partners in other large New York City law firms, [the valuation expert] ascertained the compensation level of senior associates in such firms engaged in the same area of practice as [Mr. Douglas] and adjusted upward to reflect the higher hourly billing rate attributed to him, [accurately reflected] reasonable compensation for a non-partner possessing [Mr. Douglas'] experience and skill levels." The premise behind this analysis reasons that it is axiomatic that employees with no familial or business relationship with the owner, other than a pure employer-employee relationship, would expect to receive market-level compensation for the duties they perform. By comparing the duties, education and experience of non-owner employees with those of the owner, it is reasonable to assess a level of replacement compensation based on that data. In some cases, as it was in the *Douglas* matter, it may be necessary to apply a premium to account for duties, responsibilities, skills and experience differentials between the subject owner and the non-owner employee comparables.

## Using a Specialist

There is yet another means by which to assess replacement compensation when all other avenues have been exhausted — that is the retention of a third party compensation or vocational specialist. Even this approach has its drawbacks, however. The expense involved in hiring a specialist might exceed the benefit derived. In some instances, the specialist's fees have been known to surpass even the cost of an entire valuation engagement. Care must also be taken to ensure that the specialist has a reliable background and proven reputation if the opinion they express will be relied upon for one of the most significant adjustments for valuation.

The valuation expert should not take lightly the charge to determine replacement compensation in the valuation of any privately held entity. In a recent California decision regarding the dissolution of the marriage of Dr. Boris M. and Ms. Ann E. Ackerman (*In re Marriage of Ackerman* (2006), Cal.App.4<sup>th</sup>, Superior Court of Orange County, No. 01D010971), the presiding judge dismissed the replacement compensation determinations of both parties' respective experts. In each instance, the expert relied on a distinctive industry statistical survey, each of which was generally accepted by valuation experts as an empirical study for purposes of assessing replacement compensation in the determination of goodwill for the valuation of a medical practice. Although one expert used broad national data and the other expert used region-based data, the court determined that neither was "sufficiently fine-tuned" to the Newport Beach area in which the medical practice was located, or to Dr. Ackerman's "peculiar talent, training and expertise." In addition, neither party provided an opinion from a vocational specialist with local market familiarity. Ultimately, the court did utilize a methodology that was similar to that used by one of the experts, but the final assessment of replacement compensation was determined by the court's analysis and "common sense view" rather than the statistical computations of either expert.

## Conclusion

The assessment of replacement compensation should not be undertaken without careful consideration. The valuation expert must be able to demonstrate that the analysis has been conducted using the best available data, that it was properly researched for reliability, that the components of actual compensation and replacement compensation are similar in nature and that the resulting determination is not biased and does not advocate for any position.

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