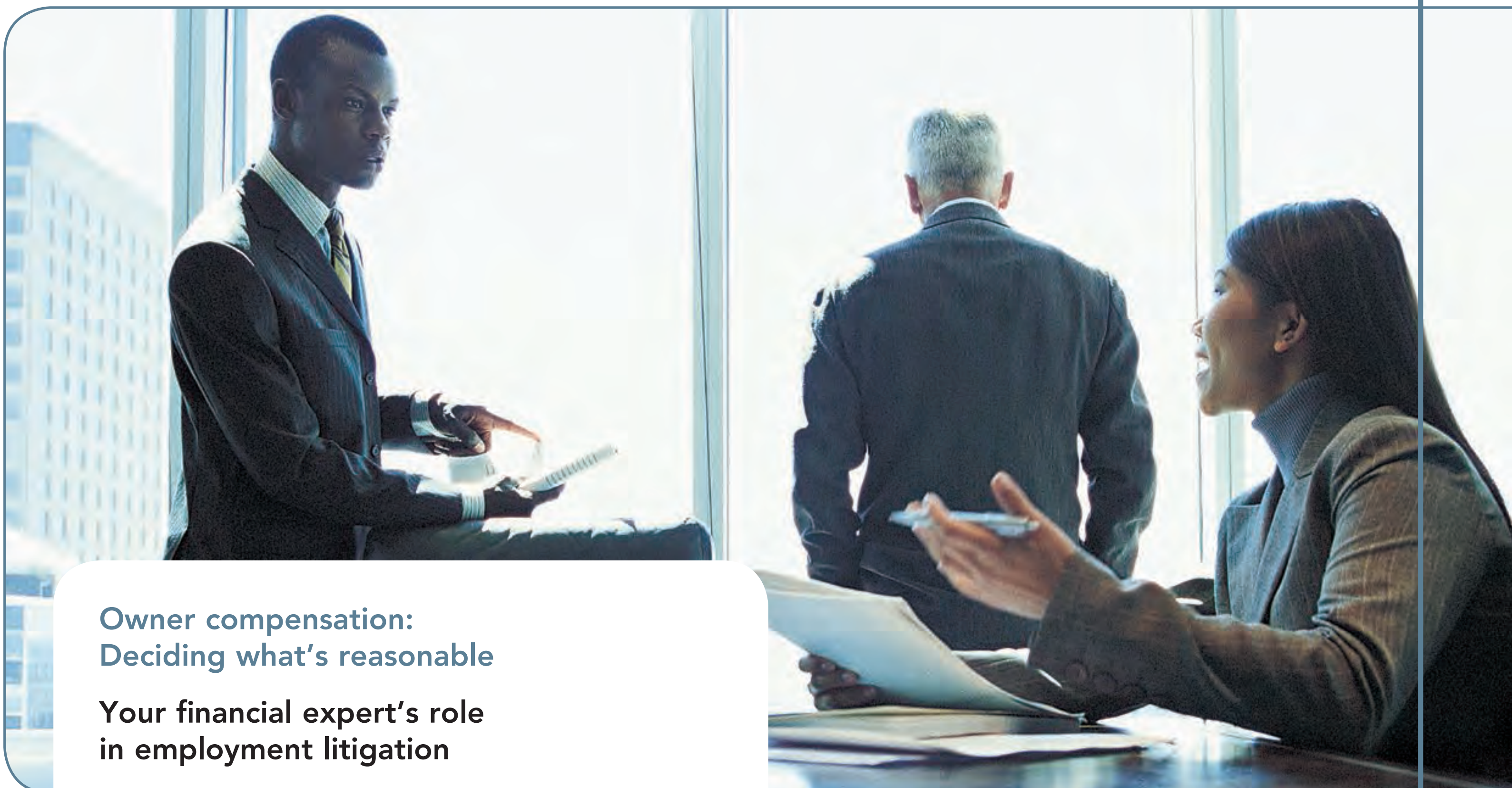
Advocate's EDGE



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Deciding what's reasonable

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Owner compensation: Deciding what's reasonable

Determining the appropriate compensation for the shareholder-owners of a corporation often proves challenging — perhaps never more so than when the IRS is involved. If the agency deems a shareholder's compensation is unreasonably high for the services rendered, for example, the excessive compensation could be treated as a constructive dividend and disallowed as a salary deduction. But as the Tax Court decision in *Thousand Oaks Residential Care Home I v. Commissioner* shows, the "reasonable compensation" evaluation isn't always as straightforward as it might seem.

RETROACTIVE COMPENSATION

In 1973, Dr. Robert Fletcher purchased a struggling corporation called Thousand Oaks Residential Care I (TORCH) for $25,000, assuming debt obligations of several hundreds of thousands of dollars. TORCH owned and operated an assisted living facility.

Dr. Fletcher oversaw TORCH's general operations, handled its finances and supervised its maintenance workers. He also performed substantial maintenance work. His wife, a nurse, managed the health care and housekeeping personnel, worked with the facility's residents (which included learning their diagnoses, handicaps and illnesses), handled family matters, and communicated with doctors, pharmacists and dietitians. From 1997 to 2001, the Fletchers took little compensation even though they paid their employees at market rates.

In 2002, TORCH sold the assisted living facility for $3.4 million. When the sale was imminent, Dr. Fletcher consulted an accountant about its tax implications. The accountant advised him that if he and his wife hadn't been paid reasonable compensation in the past, they could make a "catchup" adjustment to pay themselves more. As a result, TORCH provided Dr. Fletcher with a total compensation package of $880,939 for the years 2003 through 2005. His wife received a total compensation package of $820,348 for the same period.

TAX COURT HANDS OUT A MIXED BAG

The Tax Court in *Thousand Oaks Residential Care Home I v. Commissioner* (see main article) also ruled on several other issues.

After the sale of Thousand Oaks Residential Care I (TORCH), the corporation established a defined benefit pension plan, effective Jan. 1, 2003. TORCH made large contributions for the Fletchers in 2003 and 2004. Their accountant advised them that the contributions were benefits and could be included as compensation not previously received.

When the Tax Court found their compensation unreasonable, it concluded that Dr. Fletcher therefore received a nondeductible pension contribution of about $75,000 and his wife a nondeductible contribution of about $65,000. Therefore, the Section 4975 10% excise tax on nondeductible contributions to qualified employer plans applied.

However, the court didn't impose penalties for failure to file excise tax returns or failure to pay a penalty on the tax that would have been due on those returns. It found that the Fletchers had reasonably relied on the advice of their accountant.

The IRS determined that the compensation packages were unreasonable and disallowed deductions for all of the compensation paid for tax years 2003 through 2005. The Fletchers and TORCH appealed.

5 FACTORS

The Tax Court began its analysis by noting that catchup compensation for prior years' services is deductible in the current year if: 1) the employee was actually undercompensated in earlier years, and 2) current payments were intended as compensation for past services. Like any compensation, though, catchup compensation is only deductible under IRC Section 162 if it's reasonable.

According to the Tax Court, the reasonableness of compensation is based on five factors:

1. The employee's role in the company,
2. A comparison of the employee's salary with salaries paid by similar companies for similar services,
3. The character and condition of the company,
4. Potential conflicts of interest, and
5. Internal consistency.

Because the Ninth Circuit Court of Appeals would hear a further appeal of the matter, the Tax Court also considered a sixth factor: whether an independent investor would be willing to compensate the employee as he or she was compensated.

FACTORS FAVOR TAXPAYER

The court found that the Fletchers' roles as hands-on operators favored a finding of reasonableness. TORCH's character and condition also slightly favored reasonableness. Although the corporation wasn't profitable enough to pay the Fletchers during some years, they were able to pay down their long-term debt. And they managed to make TORCH profitable enough to pay its own bills and command a substantial sale price. The internal consistency treatment factor favored reasonableness because, while their compensation was inconsistent with payments to other employees, the Fletchers discriminated *against* themselves through underpayment.

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A comparison with salaries paid by a similar company for similar services weighed against reasonableness for 2003 through 2005. After deducting the amounts by which the Fletchers were underpaid in prior years, the court found that Dr. Fletcher's compensation for 2003 through 2005 was $638,585 and Mrs. Fletcher's was $264,410 — exceeding figures derived from the Bureau of Labor Statistics' Occupational Employment Statistics program. And the Fletchers conceded that they had a conflict of interest, which also weighed against reasonableness.

Ultimately, the court seemed to focus most on the sixth factor. Taking into account the rate of return a reasonable investor would have expected, it found that the Fletchers were overpaid by a total of $282,615. (This number was calculated by assuming a 10% return on $25,000 of $503,300 compounded over 31.5 years, *less* TORCH's retained earnings of $161,685 at the end of 2005, *less* a $59,000 disallowed salary for the Fletchers' daughter.) In other words, the Fletchers' compensation was unreasonable to the extent that it reduced the assets available to pay the investor's expected return.

PROCEED WITH CAUTION

Clients can't afford to take for granted that their compensation is reasonable. A CPA can help them determine if the IRS and the courts would agree — before it's too late.

Your financial expert's role in employment litigation

Financial experts play a critical role in wrongful termination cases and other types of employment litigation — particularly in estimating lost earnings. Such calculations tend to be complicated because experts must account for everything from earnings to retirement plan benefits to group insurance rates.

ACTUAL AND PROJECTED EARNINGS

The expert's initial focus generally is on the employee's "base earnings." This represents the earnings rate for a specific year or group of years from which lost earnings will be extrapolated. The facts of the case will determine whether the base earnings will use the actual earnings in the year before an employee was terminated, the projected earnings for the year the termination occurred or the expected rate of earnings for a year in the future.

Several types of data are needed to reach a figure for base earnings. They include:

- Employer records,
- Employee pay stubs,
- Income tax records,
- Social Security records,
- Census information, and
- The earnings of comparable employees in the industry or company.

Information related to an employee's seniority, health history or productivity declines can provide additional insight if the employee's earnings record doesn't reflect regular annual increases. Damages experts might also make adjustments for seasonal variations and sick pay. One-off, nonrecurring payments, such as a nonperformance-based bonus, have the potential to skew base earnings, as well.

BENEFITS AND PERKS

Appropriate compensation for lost pension benefits depends on the type of plan involved. For defined contribution plans, employer contributions are considered as a portion of lost earnings in the years the contributions would have been made. Rather than projecting the postretirement benefits to be paid, the expert calculates the sum of the but-for employer contributions to the but-for earnings.

Calculations for defined benefit plans, on the other hand, may require projection of the actual benefit stream following the employee's retirement. Relevant factors include years of service, salary levels, retirement date and life expectancy. One common approach to calculating life expectancy uses an average life span to project the full benefits up to the estimated time of death.

To determine compensation for fringe benefits, experts compare the benefits received before the alleged wrong to those received after — possibly taking into account the replacement cost of the lost benefits. Individual insurance rates, for example, may be higher than those paid under an employer-sponsored group plan. Experts distinguish between benefits that depend on the recipient's level of income and benefits that depend merely on being employed.

Experts also closely scrutinize those benefits to which both the employer and the employee contribute. The employee would be doubly compensated if damages were paid for his or her contribution *and* lost wages. Double recovery also could happen if vacation and sick pay are added to gross earnings.

WHEN THE PARTIES DISAGREE

Lost earnings claims can trigger several areas of dispute between parties, such as the effect of variable components of compensation. Commissions, overtime and performance bonuses must be clarified. The employee's duty to mitigate his or her damages can raise questions, too. Defendants may argue that the employee took an unreasonable amount of time to land a new job or accepted a position at an unreasonably low pay rate.

The loss period — which can range from several months to the plaintiff's entire work life — may be a subject of contention, too. Selecting an appropriate period requires analyzing a variety of factors, including the plaintiff's likelihood of securing comparable employment and the need for specialized training to qualify for a new job.

The parties may further disagree over how to handle the plaintiff's future compensation increases as they relate to retirement and mortality. The availability of specialized data that accounts for lifestyle choices, such as smoking, makes even the selection of work-life expectancy tables and statistics subject to debate.

Once experts determine lost earnings and the loss period, they select an appropriate interest rate (often based on local statutory or case law) to discount projected earnings to present value.

A HELPING HAND

Employment litigation requires financial expertise. Involve an expert early in a case so he or she can help you weigh your options and evaluate your evidentiary needs.

Do discounts apply to real estate holding corporations?

Discounts for lack of marketability (DLOM) aren't unusual when a business or real estate is valued. But what about when a business that holds real estate is valued? Can DLOMs be applied to both the real estate *and* the corporation? According to the New York court in *Giaimo v. Vitale*, the answer is yes — and that discount should account for built-in gains (BIGs).

THE DISCOUNTING ISSUE

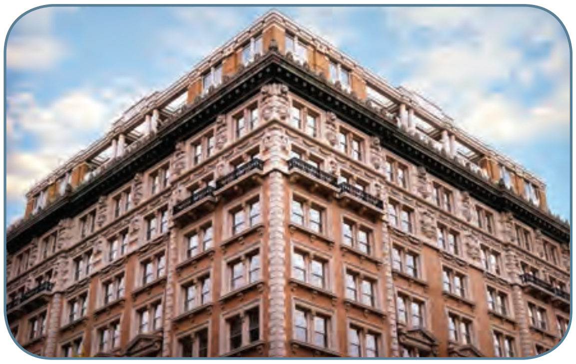
Robert Giaimo sued Janet Giaimo Vitale to dissolve two closely held corporations whose assets comprised 19 residential buildings in Manhattan. The lower court was tasked with determining the fair value of the two holding companies. It decided to disallow any DLOM, pointing out that the buildings themselves were quite marketable.

The court of appeals disagreed. It noted that the lower court correctly held that the method of valuing a closely held corporation should include any risk associated with the illiquidity of the shares. But it found the court had erred in determining that the marketability of the corporations' real property assets was exactly the same as the marketability of the corporations' shares.

The appellate court acknowledged that some shared factors affected the liquidity of both the real estate and the corporate stock. But it also stated that there were increased costs and risks associated with corporate ownership of the real estate in this case that wouldn't be present if the real estate was owned outright. Those costs and risks negatively affected how quickly and with what degree of certainty the corporations could be liquidated, and the impact should have been accounted for with a discount.

THE BIG ISSUE

The court also rejected the plaintiff's argument that a discount for embedded capital gains taxes can never be included in a fair value calculation. It found that such taxes will affect what a hypothetical willing buyer would pay for the corporate stock.



On the other hand, the court rejected the defendant's contention that the BIG discount must always be calculated at 100% of the projected tax as of the date of valuation. Some courts have concluded that this method assumes a buyer would immediately sell all of the real estate and realize the full capital gains impact. The *Giaimo* court concluded that reducing the BIG to present value appropriately adjusts for embedded capital gains taxes that won't be paid until some point in the future.

THE BOTTOM LINE

The *Giaimo* decision is a good reminder that the value of a real estate holding corporation isn't necessarily the same as the value of its assets. An experienced appraiser will look beyond just a corporation's assets to reach a value conclusion that can hold up in court.

Artificial intelligence gives fraud detection a boost

As fraud schemes become more sophisticated, so do fraud investigations and detection techniques. One of the hottest new fraud-detection tools is the use of artificial intelligence to complement investigators' efforts.

FLEXIBLE AND ADAPTABLE

Artificial intelligence refers to the use of computer systems to perform tasks that typically require human intelligence. It can involve visual perception, speech recognition, decision making and language translation.

Artificial intelligence applications are particularly well suited for fraud detection. They're flexible and easily adaptable, meaning they can adapt to new business conditions. The applications also can find relationships that were previously unknown. And because they learn from experience, artificial intelligence applications don't need to be programmed for all of the operating conditions under which they must perform. This is especially important in fraud detection, because not every condition can be known.

Such applications are faster and more accurate than human investigators — an advantage in a world that abounds with massive amounts of data previously unavailable. With artificial intelligence lending a hand, fraud investigators can concentrate their efforts on components requiring human input, such as one-on-one interviews and evidence analysis.

DETECTION TECHNIQUES

Several types of artificial intelligence have been used to detect fraud:

Neural networks. Neural nets have been used to detect fraud in banking and credit card transactions. A network is "trained" to identify fraudulent activity by comparing aspects such as the time, frequency, size and type of transaction with an existing model established for each customer. It sends up a red flag when it spots irregular spending behaviors.

Genetic algorithms. Genetic algorithms are search techniques based on the process of natural evolution, including such concepts as inheritance, mutation and selection. Taking the concept of survival of the fittest, they "mate" the most effective solutions to produce even better ones. In the fraud arena, this leads to the development of improved detection techniques over time. At least one bank has used genetic algorithms to develop stronger techniques for signature recognition.

Fuzzy logic. Fuzzy logic deals with figures or values that are approximate, rather than specific. It permits the consideration of grey areas, as opposed to applying only hard and fast rules or thresholds. For example, traditional fraud detection software might flag a transaction of $500 as large, and therefore suspicious, but ignore a $499.99 transaction. Fuzzy logic would also regard as suspicious some transactions just under the $500 threshold.

COMPLEMENT, NOT REPLACE

Like any fraud detection technique, artificial intelligence generally indicates only data that might be suspicious. It still takes a trained fraud expert to analyze the data, conduct an investigation and confirm that malfeasance has occurred.