Reasonable Compensation in the Valuation of Professional Practices and Small Businesses

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There are various methods used to value professional practices and small businesses, one of which—the excess earnings method—requires a determination of the reasonable compensation of the owners and executives. There are various databases and web sites that provide data regarding the compensation of various professionals and executives, and that data, even if it were perfectly reliable, may be used incorrectly. The misuse of the data necessarily results in an incorrect valuation of the professional practice or business. This article will focus on one area of misuse that the author has seen on various occasions.

To understand the misuse of the compensation data, one must first understand the underlying concept of reasonable compensation. A business valuator must put him or herself into the shoes of a hypothetical investor/buyer. An investor might consider buying a business that has no profits because the owners are taking huge salaries. The hypothetical investor would then assume that he/she could bring in his or her own management team to replace the owners. The new management would be equal in skill and work habits, but they would be paid the going market rate for their services. The going market rate would take into consideration the employees' role and job description in the company, the industry in which the business operates, the character and condition of the company, the location and size of the business and the compensation being paid by similarly positioned companies. After paying the new management the fair market rate of compensation, the profits of the company would increase because reasonable salaries would replace the inflated old salaries. The investor would then base his investment decision on the revised profit earning capacity of the company that theoretically has the new management in place.

With the above understanding in mind, it is therefore necessarily true that the investor would need data that details the amount of money that needs to be paid to replace current owners with **employees.** If the data provides compensation information of **owners,** rather than employees, then that information is not what is needed. In other words, the investor himself will be the new owner, and he would want to hire employees to run the business, and so he needs data regarding the fair compensation paid to employees that operate a business similar to the one he wishes to acquire.

For large companies, who have CEOs and other executives—and note that CEOs and executives are usually employees—there are databases that provide reasonable compensation for those types of executives based on the industry, location, and size of company. For professional practices and small businesses, however, many of the databases provide information that really portrays the total compensation and earnings of the owner as owner, rather than just the reasonable compensation of the owner for the services he renders. Those databases therefore include profits or profit sharing in their compensation data, and therefore the information being given has two components. One component of the owner's compensation is compensation for the actual services that the owner renders. The other component is profits that the owner receives because he is an owner, or part owner, as in a partnership. That second component has to be eliminated by an investor looking for compensation data for a potential employee, because he—the investor—wants to keep that profit component for himself.

Various experts have explained the above as follows. Shannon Pratt, Robert Reilly and Robert Schweihs state, “The general idea of the compensation adjustment is to substitute the cost of hiring and paying a nonowner employee for the compensation actually paid to the owner to perform the same function.” [1] Gary Trugman explains, “The officer’s compensation adjustment is intended to restate the economic income statement of the company to a basis that includes the amount of salary that would be necessary to attract others that are qualified to perform the duties required by the company. I usually put myself in the position of an investor who will have to hire a replacement for the present management. How much will I have to pay to replace them going forward? Many factors should be considered in the determination of reasonable compensation. Consider among others, the type of duties, education, experience, the number of hours worked, and the geographical region of the country.” [2] Edward Poll adds that one should, “fix the amount by which the law practice exceeds what an employee of comparable qualifications would earn. Compare education, training, and skill effort by way of number of hours worked.”[3] Finally, Brian Brining explained, at a business valuation conference in Los Angeles that, “A reasonable salary level for the owner or owners should be based solely on the services performed. The objective is to determine what the owner should be paid if that person did not own the company.”[4]

An example that explains the above concept would be a theoretical case that involves a 50-year old sole practitioner lawyer who earns approximately $400,000 per year. If one were to utilize the survey by Altman Weil, Inc., a company that prepares statistics regarding lawyers, one would see that lawyers whose age is similar to that of the subject lawyer and who were partners in their law firms earn approximately $400,000 per year. That data, even if it is accurate, must be adjusted to eliminate the component of compensation that is derived from profit sharing. One cannot look at similar 50year-old partners of other firms to determine the reasonable compensation of a subject 50-year-old lawyer who owns his legal practice, because the compensation to those partners consists of two components—one component is for services rendered—and the other is profit sharing for owning part of the law practice. An investor who would buy out the law practice would, in his or her mind, remove the subject lawyer from the practice, and substitute him with an equally talented, equally hard working lawyer, who would be paid a market rate for the services rendered, while the investor would keep the profit sharing/ownership component. Therefore, what should be done in the valuation of this theoretical solo law practice is to try, difficult as it may be, to determine what the lawyer’s reasonable compensation should be just for the services rendered. This can be done by looking at the highest paid associates in that type of law practice and adding a premium, or by looking at the compensation of partners in that type of law practice and discounting out the profit portion, or sometimes by looking at government employees of high ranking who do the same type of work.

One reason why people who prepare reasonable compensation analyses on a frequent basis make the mistake of looking at partner or owner compensation studies is because their work is primarily related to a major income tax issue regarding reasonable compensation, and that is very different from the business valuation issue. The Internal Revenue Code, in Section 162(a)(1), provides that “There shall be allowed as a deduction all the ordinary and necessary expenses paid in carrying on any trade or business including reasonable allowance for salaries or other compensation for personal services actually rendered.” There have been many disputes between taxpayers and the IRS as to what is reasonable. The many cases regarding this issue have reflected certain guidelines, one of which is that the reasonableness should be determined as if one were examining the issue “from the perspective of a hypothetical independent investor.” That sounds just like the comments above, but the history of case law then adds various guidelines, including external comparison with other companies. What therefore happens in reality is that if the IRS challenges the reasonable compensation of a professional, as an example, the defense against the challenge is to produce surveys like Altman Weil or similar surveys that reflect that the professional’s salary is reasonable since everyone else of his age or location is being paid the same. The investor model disappears and the comparative model intensifies, from the perspective of the party claiming the deduction, and case law has allowed that.

Therefore, a person who prepares a reasonable compensation analysis for the exact same individual for purposes of defending an IRS audit will come to a different conclusion than he would if he were properly preparing the analysis for a business valuation.

In summary, for purposes of determining reasonable compensation in a business valuation, it is extremely important to use the correct methodology and to understand the underlying theory of the valuation model. Approaches that work well with IRS audits do not necessarily have any relevance in the calculation of the value of a business.

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Endnotes

[1] Shannon Pratt, Robert Reilly and Robert Schweihs, *Valuing Small Businesses and Professional Practices,* Third Edition, 1998, Page 118.

[2] Gary Trugman, CPA, ABV, CBA, ASA, CFE, MVS, AICPA, *Understanding Business Valuation, A Practical Guide to Valuing Small to Medium-Sized Businesses*, 1998, Page 112.

[3] *Aspen Law & Business–Valuing Professional Practices and Licenses,* Third Edition, 2003, page 16-18.

[4] 1998 Business Valuation Conference, California CPA Education Foundation, page 2 of the section entitled “Value of Owner’s Services, Theory and Practice,” by Brian Brining, JD, CPA.