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COURT CASE ABSTRACT

IRS Falters Under 'Five Factors' Test for Reasonable Compensation

Vitamin Village, Inc. v. Comm'r, 2007 Tax Ct. Memo LEXIS 278 (September 12, 2007)

Federal appeals courts have been moving away from "multifactor" tests to determine reasonable compensation under Internal Revenue Code (IRC) section 162(a)(1) ever since the Seventh Circuit strongly rejected the Tax Court's seven-factor approach in *Exacto Spring Corp. v. Commissioner* (1999). "The Judges of the Tax Court are not equipped by training or experience to determine the salaries of corporate officers," the Seventh Circuit held. "[N]o judges are." Rather, "[t]he federal courts of appeals...have been moving toward a much simpler

and more purposive test, the 'independent investor' test....We applauded the trend and join it."

Exacto cited the Ninth Circuit decision in *Elliotts, Inc. v. Commissioner* (1983) in support, even though this case applied five factors to determine reasonable compensation under section 162(a)(1), one of which (conflict of interest) frames the inquiry from the perspective of an independent, inactive investor. *Elliotts* remains the leading authority in the Ninth Circuit and guided the Tax Court's inquiry in this case.

Nutritional company starts out lean

Daniel Reeves started Vitamin Village in 1979 to produce and sell nutritional supplements and related health food and sports performance products; the company also provided indoor tanning and printing/marketing services. Over the years, Reeves served as president, treasurer, secretary, and sole shareholder, working more than eighty hours a week to perform all duties. In 1994, Reeves spun off the tanning and advertising services into two separate corporations, maintaining executive control and ownership of both. While the new enterprises took away some of his time, Reeves maintained his primary responsibilities at the original business.

In its first few years, Vitamin Village struggled and paid Reeves little or no salary. The company did not maintain a formal compensation policy, but internal memoranda consistently noted that Reeves had received less than full and adequate compensation during the early years and would be considered for a salary increase in the future. Beginning in 1993, business improved substantially, due to increased marketing. In fiscal years 1995 and 1996, the company paid Reeves \$2,278,000 (including a \$2 million bonus) and \$1,012,000 (\$1 million bonus), respectively.

The IRS determined that only \$1 million of compensation in 1995 and \$750,000 in 1996 were reasonable and deductible under IRC section 162(a)(1). At trial, it presented a report from an accredited financial analyst, who reviewed the company's historic revenues and net income and its tax returns for 1995 and 1996. He then compared Reeves' compensation to that of CEOs in five publicly traded

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comparable companies using four different metrics, including the average CEO compensation and a regression analysis of the compensation-to-sales ratio. His conclusion: \$1,010,678 was reasonable pay for Reeves in 1995, and \$750,936 in 1996.

Analysis must include all facts

The Court noted calculation errors in two of the expert's conclusions—one in excess of \$250,000—and made adjustments accordingly. The expert also conceded that a few of the selected comparables suffered significant losses in 1995 and 1996, which may have led them to cut executive compensation, thus understating their value in the analysis. Due to the limitations of his review, the expert was unable to account for all relevant facts and circumstances, and the Court noted these points in its five-factor Elliotts analysis:

1. Role in the company. Reeves' work and vision were critical to the business. Despite managing the two other companies, he remained "highly motivated" and a "driving force" behind the business' ultimate success.
2. External comparison. The IRS expert admitted that an employee (like Reeves) who served several positions within the same company could receive higher compensation as a result. Further, a company that underpays an employee in low-income years will often make up the shortfall in more profitable years, including reimbursement for the time value of money. Executives presiding over highly profitable years may also be entitled to increased compensation. Finally, because public companies have up to 5% more costs than private companies, they may have less income available as compensation.
3. Character and condition of the company. This focuses on the company's size (sales, net income, or capital value), its complexity, and general economic conditions. In this case, the company was small but had secured a relatively profitable niche; its growth (gross sales) increased substantially after 1993, and its return on equity reached 93% in 1995 and 25% in 1996. Although not complex, the company's operation was no "simple task" for Reeves, especially given the success he helped it achieved.
4. Conflict of interest. "Heightened scrutiny" is required when corporate officers set their own compensation, especially when coupled with absence of dividends. Elliotts looks to a hypothetical investor's

returns on equity (ROE): If a company's earnings after payment of compensation meets an average of 20% ROE, "there is a strong indication that the employee is providing compensable services, and that profits are not being siphoned out of the company disguised as salary." In this case, the 93% and 25% ROE "substantially exceeded" the guideline companies' average ROEs of 5.9% and -54.4% during the same years.

5. Internal consistency. The company had no "structured, formal, and consistently applied" compensation program. But it made formal provision to reimburse Reeves in the future for the sacrifices he made during the "lean" years.

Under these facts, and including adjustments for errors and underpayments, the Court found that reasonable compensation totaled \$2 million in 1995 and \$1,012,000 in 1996.

SPECIAL REPORT

IRS Extends 409A Compliance Deadline to Next Year

The Treasury Department and the Internal Revenue Service (IRS) recently announced that taxpayers will have until December 31, 2008, to bring documents into compliance with the final nonqualified deferred compensation regulations under section 409A of the Internal Revenue Code. Last April, the Treasury and IRS issued final 409A regulations, which provide guidance regarding the requirements for deferral elections and payment timing under section 409A. Affected plans and arrangements were originally required to comply with the final regulations by December 31, 2007.

IRS Notice 2007-78 extends the document compliance deadline for one year and provides additional limited transition relief. Importantly, the Notice does not postpone the effective date of the final regulations, which were already extended once, from January 1, 2007, to January 1, 2008). The Treasury and the IRS anticipate issuing further guidance "containing a limited voluntary compliance program that will permit taxpayers to correct certain unintentional operational violations of § 409A and thereby limit the amount of

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additional taxes due under § 409A,” although the Notice does not indicate when to expect the additional guidance. A copy of the Notice is posted at www.irs.gov/pub/irs-drop/n-07-78.pdf.

COURT CASE ABSTRACT

37% Discount Denied in Poorly Executed FLP

Estate of Bigelow v. Comm’r, 2007 U.S. App. LEXIS 22030 (September 14, 2007)

Add Bigelow to the ever-growing list of “bad facts” cases concerning family limited partnerships (FLPs). An eighty-five year-old widow owned California beach property, worth about \$1.45 million. Given her health concerns, she transferred the property to a trust and then to an FLP. The trust became the sole general partner and a limited partner, in exchange for \$500. Her two children each contributed \$100 to become limited partners.

The debt on the beach property was not transferred to the FLP and remained Mrs. Bigelow’s personal liability. During her lifetime, however, the FLP used partnership funds to make substantial monthly payments on the loan. As her revenue sources dwindled and her expenses increased, the FLP also covered the shortfall, characterizing these payments as “advances” on her partnership account—but without receiving a note or other obligation in return. Only after the widow died, in 1997, did the partnership reduce her capital account to reflect these payments. The FLP sold the property for \$1.475 million and distributed the proceeds to the remaining partners and her estate—the first (and last) distributions in its history.

Implied agreement to enjoy FLP income

On its tax return, the widow’s estate applied a 37% discount for lack of control and marketability to its interest in the FLP. The IRS assessed a \$200,000 deficiency based on the full value of the beach property, minus the remaining mortgage obligation but excluding any discounts. The Tax Court upheld the deficiency, finding an implied agreement between the widow and her children that she would retain the right to the FLP income to meet her living expenses. Further, the transfer of the property to the FLP did

not meet the “good faith, bona fide sale” exception of Internal Revenue Code (IRC) section 2036(a), as the transfer would have “impoverished” the widow but for the implied agreement to use partnership funds to meet her financial needs.

On review, the Ninth Circuit Court of Appeals agreed with both findings. The partnership’s payments on the widow’s personal loan obligations, without receiving any obligation in return or deducting the amounts from her partnership account until after her death, supported the implied agreement. Another problem: The FLP deducted only the payment of principal from the widow’s capital, not the interest. The FLP also failed to observe partnership formalities and lacked any legitimate business purpose. It did not shield the partners from potential liability, and although the FLP may have facilitated gifts to her heirs, “gift-giving is considered a testamentary purpose,” the Court ruled, “and cannot be justified as a legitimate, non-tax business justification.”

Ninth Circuit declines to adopt ‘per se’ rule

Finally, although the estate contended that the widow received a proportionate number of limited partnership shares in exchange for the fair market value of the property, it also claimed a substantial discount in valuing the property for estate tax purposes. The Commissioner argued that these positions were inconsistent, but the Ninth Circuit Court declined to adopt the “per se” rule.

We agree with the Third and Fifth Circuits and the Tax Court that an inter vivos transfer of real property to a family limited partnership, which inherently reduces the fair market price of the resultant partnership interests does not per se disqualify the transfer from falling under §2036(a)’s exception.

To avoid the reach of section 2036(a) in this case, the estate needed to demonstrate “more than a proportional exchange” between the fair market value of the property (at \$1.45 million) and the \$100 limited partnership units. The estate also needed to show a “genuine” pooling of assets and the related potential for creating intangible value from the amassing of assets. “The validity of the adequate and full consideration prong cannot be gauged independently of the non-tax-related business purposes involved in making the bona fide transfer inquiry,” the Court held. Under the facts of this case, it affirmed the Tax Court’s decision in all respects.

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