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VALUATION Trends
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What's Reasonable Compensation?

***Aries Communications Inc. and Subsidiaries v. Commissioner,* T.C. Memo 2013-97 (April 10, 2013)**

The Tax Court has determined how much of the amount paid by a corporation to its chief financial officer (CFO) and sole shareholder (including "catchup" payments for undercompensated prior years) was reasonable compensation deductible by the corporation under Code Section 162.

For compensation paid by an employer to be deductible under Code Section 162, the amount must be reasonable, and the payment must be purely for services rendered. What is reasonable depends on the facts and circumstances of each case.

The Ninth Circuit Court of Appeals (to which an appeal of this case would lie) uses five factors to determine the reasonableness of compensation, with no single factor being determinative: (1) the employee's role in the company; (2) comparison with other companies; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) internal consistency in compensation (Elliotts, Inc., (CA 9 1983) 52 AFTR 2d 83-5976). The Ninth Circuit also considers an additional factor-whether an independent investor would be willing to compensate the employee as he was so compensated (the "independent investor" test). Compensation for prior years' services ("catchup payments") can be deductible in the current year as long as the employee was actually undercompensated in prior years and the current payments are intended as compensation for past services.

N. Arthur Astor was president, CFO, and sole shareholder of Aries Communications Inc. ("Aries") from its incorporation in 1983. Mr. Astor acted as general manager of each of Aries' radio stations. He was a "hands-on" manager who was actively involved in many aspects of Aries' day-to-day operations. His duties included: (1) oversight of Aries' other management personnel; (2) planning and overseeing the execution of programming; (3) negotiating and communicating with Aries' lenders; (4) participating in sales meetings; and (5) communicating with outside advisers (such as lawyers and accountants).

Aries had two subsidiaries, Orange Broadcasting Corp. ("Orange") and North County Broadcasting Corp. ("North County"). In May 2003, Orange sold its FCC license for 94.3 FM for $35 million. In April 2004, North County sold certain assets of 92.1 FM, including FCC licenses, equipment, engineering data, and selected contracts, for $18 million. Mr. Astor was personally involved in both sales and instrumental in the significant increase in the sales price from the initial offering of $18 million to $35 million for 94.3 FM, and from $12 million to $18 million for 92.1 FM. Mr. Astor also guaranteed $20 million in loans from Goldman Sachs Credit Partners L.P. to Orange.

Aries had gross receipts of over $4.5 million before it sold off these major assets. However, it lost money each year from 1999 to 2002. Immediately after the two years of the major asset sales, it began losing money again.

On its return for the tax year ending Aug. 31, 2004, Aries claimed a deduction for $6,896,974 of compensation paid to Mr. Astor. On audit, the IRS disallowed $6,086,752 of this amount, determining a deficiency of $2,676,002.

The Court reviewed six factors for determining reasonableness and found them either favoring the reasonableness of the compensation, not favorable or neutral.

Employee's role. Both Aries' and the IRS's experts agreed that Mr. Astor was Aries' most important employee. He facilitated the sale of Aries' assets for prices far exceeding the buyers' original offers. Further, Mr. Astor also facilitated the Goldman Sachs debt by way of his personal guarantee (favorable factor).

Comparison with other companies. Mr. Astor had significant involvement in his executive capacity, acquiring, managing, and selling the investments. He was responsible for increasing the sales price from $12 million to $18 million (or by 50 percent). Even given his dual status as shareholder and chief executive officer, his efforts as an employee were still entitled to reasonable compensation for services rendered. The Tax Court, using its best judgment, found that Mr. Astor's appropriate bonus would be one-third of the increase in the sale price (i.e., $2 million) (not a favorable factor).

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Company's character and condition. Aries was a large, asset-laden, complex business with a negative net income and a bleak financial picture despite the successful asset sale during the year at issue. The facts suggested the possibility that Aries was thinly capitalized (not a favorable factor).

Potential conflicts of interest. An independent investor would have desired the highest prices for the assets and rewarded Mr. Astor for his shrewd negotiations to that end. However, as Aries' owner, he also had a significant interest in getting the highest price for the assets and then receiving the reward as salary deductible by Aries instead of as a nondeductible dividend. In addition, Mr. Astor was well compensated ($2,074,983) for his work in investing in and maintaining Aries' major assets in the year immediately before the year at issue (when the first major asset sale took place) (not a favorable factor).

Internal consistency. Mr. Astor's compensation was not awarded under a structured, formal, consistently applied program. Accordingly, it was suspect. However, Mr. Astor's compensation included amounts for prior years of hard work for which he was undercompensated (neutral factor).

Independent investor standard. Aries had a net income of $4,025,956, after taxes and the compensation packages were paid in the year at issue, and retained earnings of $12,725,862. The company had enough retained earnings to almost satisfy an investor even at 20 percent compounded annually after Mr. Astor's compensation was paid in 2004 (favorable factor).

The Tax Court, after reviewing all of the factors, held that Mr. Astor's compensation was not reasonable, and that Aries could not deduct the entire amount of the claimed compensation expense. However, the Court found that $2,660,899 – Mr. Astor's fixed salary of $199,274 plus $461,625 of underpayments for the four years reviewed by the Court, plus the $2 million bonus – was deductible as reasonable compensation.

Beware of Experts Who Misuse Statistics

Our firm was hired to be a rebuttal expert on behalf of the defendants in a damages litigation regarding the value of some domain names. The company had generated revenues of about $254,000. The expert valued the domain names (40 in total - 2 active and 38 very minor) at about $8.5 million.

However, this expert, who had graduated from "Harvard with honors" (which he kept emphasizing), never got the opportunity to get far with his testimony, as we provided the attorneys with a considerable amount of ammunition to attack his methodology. He claimed to use a correlation coefficient (that is statistics for those of you that are wondering) to support a 51 percent reduction of the multiple that he location in a transaction from the year 2000. However, the valuation date in this matter was 2004. You may recall that the technology sector collapsed in 2000, so the expert used the change in the NASDAQ to support his adjustment.

Here is what can happen to an expert who uses statistics improperly.

VOIR DIRE EXAMINATION

Q. Mr. Expert you talked about the application of an adjustment factor in reaching this 51 percent or reaching whatever adjustment you immediately need today to make up for the passage of time between 2000 and 2004 correct?
A. Yes.

Q. That was what you called a correlation coefficient, correct?
A. In my report that's the phrase I use yes.

Q. That was to correlate the decline in the NASDAQ to the value of the acquired company in 2004?
A. That was to account for some of the decline in the NASDAQ that's correct.

Q. Correlation coefficient is a way of establishing the probability of an event occurring?
A. Correct.

Q. That's a statistical analysis?
A. That's correct.

Q. The possible range of a correlation coefficient is typically zero to one?
A. Yes.

Q. And in your opinion there are two ways to calculate the correlation coefficient right?
A. I'm not sure I understand what you're asking.

Q. So my question was Mr. Expert in your opinion there are two ways to calculate a correlation coefficient.
A. Are there at least two ways.

Q. Mr. Expert --
A. There are at least two ways.

Q. And what you told me before was one way is to use a table if a table exists. Correct?
A. Yes.

Q. But there was no table for this drop in the NASDAQ correct?
A. That's correct.

Continued on next page...

Q. So the other way it has to -- the other way in determining the correlation coefficient is that it is a judgment call. Right?
A. Yes.

Q. So instead of a table you relied on your expertise and the factual environment in the marketplace right?
A. Yes.

Q. And then you did a sensitivity analysis to decide what percentage of the drop in the NASDAQ to attribute to the value of the acquired company as of March 2004 right?
A. Yes, sir. I think you're reading from my deposition.

Q. But you determined the correlation of the decline to be a range from zero to .5 correct?
A. Yes.

Q. Using the statistical analysis we just discussed?
A. Yes.

Q. And with that information you then did the calculation that you used to come up with this valuation for these assets that we're talking about today correct?
A. Yes.

Q. But you're not an expert on statistical analysis are you?
A. I'm not.

Q. Let's talk about correlation coefficient some more. Because you don't have any idea how to calculate that, do you?
A. I'm sorry.

Q. You don't have any idea how to calculate a correlation coefficient do you?
A. But my analysts do.

Q. But you don't?
A. No. That's why I employ analysts.

Q. And you didn't calculate that?
A. No, I did not.

Q. Exhibit J to your deposition – It's your exhibit notebook from your deposition. Now Exhibit J to your deposition was a draft report as of December 20. Right?
A. Yes.

Q. I believe it's on page 7 of your draft report where there is the discussion of the correlation coefficient and you told me that the red notations on this were your handwriting. Correct?
A. Yes.

Q. And beside the correlation coefficient there is a note that says question mark point 50 why underlined question mark. Do you see that?
A. Yes, I do.

Q. Now on the next page at the top you wrote worst case if used entire 50 percent NASDAQ then value drops and we're not going to talk about the numbers. You wrote that didn't you?
A. Yes.

Q. So even if you were wrong the damages are still high. Right?
A. No. Damages are 7.1 million.

Q. I haven't asked for that yet. I don't know how appropriate that was for you to blurt something like that out. Correlation coefficient isn't computed by using somebody's expertise or market factors or anything like that is it?
A. I'm sorry. I didn't understand what you asked.

Q. Correlation coefficient it's not calculated by using somebody's judgment or their expertise in the market is it?
A. Are you I'm not sure if you're asking me did I use my judgment to set the correlation coefficient.

Q. Well, because --
A. If your --

Q. There is a note in your report that refers to Investopedia right?
A. I missed that.

Q. There is a note your report footnote 20 that refers to a website called Investopedia. Are you familiar with that?
A. I don't have the note here so I'll have to turn to it.

Q. Have you found that note?
A. I don't have the note here.

Q. No. The footnote on your report.
A. Right.

Q. Footnote 20 on that same page you were just looking at?
A. Right. Correlation coefficient is the measure to determine the degree to which two variable movements are associated.

Q. And that website also shows you how to calculate it doesn't it?
A. Right.

Q. Now --

Continued on next page...

A. I'm sure it does.

Q. That's the printout from the link as noted in the report. And it gives a specific formula for calculating coefficient -- or correlation coefficient doesn't it?
A. I don't know. I didn't I did not calculate the correlation coefficient, so I didn't look at this formula. One of my analysts did it for me.

Q. Let's talk about that and see if someone actually did. Because it says in here a correlation coefficient will vary from negative one to positive one. Right?
A. We'll have to read it together.

Q. Sure. First page?
A. You'll have to point that out to me.

Q. First page.
A. It says correct correlation coefficient will vary from a negative one to a positive one.

Q. But you told me earlier that the correlation coefficient would vary from zero to one with. Right?
A. Well then I misspoke.

Q. And you're wrong weren't you?
A. Then I must be wrong.

Q. And in fact, you don't just use a formula and you don't just use your expertise. There is a specific formula correct do you see this?
A. I do.

Q. Statistics department at Yale?
A. Which is a very good school.

Q. Not quite as good as Harvard maybe but pretty good. And it says the same thing it always takes a value between negative one and one. Right?
A. Yes.

Q. Now, you come up with a range from zero to .5 of a correlation coefficient. But this formula doesn't yield a range it yields a specific number doesn't it?
A. Well we knew we weren't going to come up with a positive number.

Q. Well you don't know how to apply it so you guys didn't calculate using this formula did you?
A. I don't know which formula my analyst used.

Q. Because they didn't come up with a number they came up with a range and you decided what part of that range you wanted to use. Right?
A. We used the range that -- we used the number that was most appropriate.

Q. Not using this formula though?
A. I did not do the calculation.

Q. So somebody in your office just guessed and didn't run this formula because they didn't come up with a specific number isn't that true?
A. I cannot tell you that one way or the other sir. I did not do the correlation coefficient calculation.

Think the expert might have had a bad day? You bet. The judge excluded his testimony. While this may seem like an extreme case, it really is not. This type of work goes on regularly. As a firm that provides expert witness services, we are offended by others that give such a black mark to our profession. Fortunately, the judge in this case understood why the expert should not be allowed to testify.

The moral of this story is really twofold; first, if you are going to hire an expert to testify about a subject, you really must make sure that your expert understands the subject matter and does not solely rely on someone else in his/her office to perform calculations. The expert does not have to be a statistician to use statistics since our training as valuation analysts includes the statistics that most of us use in the application of our profession. You do, however, have to understand what is used.

The second part of this story is that an expert's work MUST be intellectually honest. Performing services for a client where the expert ignores certain data to derive a desired end result will make the expert short-lived in this business. We do not care how much the client pays us, our reputation is worth too much to lose it. It is bad enough when bad case results happen to honest analysts. If you do this work long enough, you are sure to have at least one opinion go against you. However, if you do things intentionally that cause them to happen to you, you probably will get what you deserve.

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