

# Valuation & Litigation Briefing

JANUARY/FEBRUARY 2024



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*Clary Hood, Inc. v. Commissioner*

# Tax Court provides guidance on determining reasonable compensation

**T**he issue of reasonable compensation frequently comes up when valuing a business. The U.S. Tax Court recently provided valuable guidance on the determination of reasonable compensation as well as the sufficiency of expert testimony on the subject.

The issue in *Clary Hood, Inc. v. Commissioner* was whether salary and bonuses paid to a corporate CEO were deductible as reasonable compensation or whether a portion of these amounts represented disguised dividends, which aren't deductible. Although this case involved a federal tax issue, the court's analysis also may be relevant to determining reasonable compensation in other contexts, such as shareholder disputes and divorce matters.

## Skyrocketing revenue growth

The business owner in the case founded his land-grading and excavation company in 1980, and he and his wife served as the company's sole shareholders and directors. As CEO, the owner grew the C corporation from a two-person operation to a 150-employee business, with nearly \$70 million in revenue by 2016. His talents and leadership were largely responsible for the company's skyrocketing revenue during the review period (2000 to 2016).



For much of the review period, the owner's salary and bonuses totaled well under \$500,000. In 2014, based on discussions with the company's accountants, management determined that the owner had been undercompensated for years and decided he was entitled to \$5 million bonuses in 2015 and

2016. These amounts were intended to bring his compensation in previous years up to a reasonable level given his significant contributions, as well as to compensate him for personally guaranteeing surety bonds and business debt over the years.

The IRS determined that the owner's compensation in 2015 and 2016 exceeded reasonable levels. It allowed the company to deduct only \$517,964 of the \$5,711,105 in compensation paid to the owner in 2015, and only \$700,792 of the \$5,874,585 paid to him in 2016. As a result, the IRS assessed significant tax deficiencies plus penalties for substantial underpayments of income tax.

## Multifactor approach

To determine reasonable compensation, the court applied the multifactor approach applicable in the U.S. Court of Appeals for the Fourth Circuit, which had appellate jurisdiction over this case. Factors considered include:

- ◆ The employee's qualifications,
- ◆ The nature, extent and scope of the employee's work,
- ◆ The size and complexities of the business,
- ◆ A comparison of salaries paid with gross income and net income,
- ◆ Prevailing general economic conditions,
- ◆ Comparison of salaries with distributions to stockholders,
- ◆ Prevailing compensation rates for comparable positions in comparable companies, and
- ◆ The company's salary policy as to all employees.

## Sources of reasonable compensation data

When deciding whether compensation is reasonable, the U.S. Tax Court often puts significant emphasis on prevailing compensation rates for comparable positions at comparable companies. Here's a sampling of general and industry-specific compensation data:

- RCReports,
- Economic Research Institute Assessor Platform,
- Salary.com CompAnalyst Market Data,
- WTW Salary Surveys,
- RMA Annual Statement Studies,
- Payscale Salary Survey,
- The U.S. Securities and Exchange Commission's EDGAR database (for public companies),
- Medical Group Management Association Data Drive (for physicians),
- Guidestar's application programming interfaces (for not-for-profit organizations),
- PAS, Inc. Executive Compensation Survey for Contractors (for construction companies), and
- Altman Weil, Inc. Compensation Program Review (for law firms).

Additional factors for small businesses with a limited number of officers include the employee's compensation in previous years and the employee's personal guaranties of corporate obligations. The court noted that no single factor is decisive. Rather, the court weighs "the totality of the facts and circumstances" in making its decision.

### Tax Court findings

The Tax Court held that the CEO's compensation was excessive and reduced the deductible amount. It found four factors to be most relevant and persuasive:

1. The company's history of never declaring or paying dividends, despite its profitability,
2. Prevailing compensation rates at comparable businesses,
3. The setting of owner's compensation (by the owner and his wife, as directors), and
4. The owner's involvement in the company.

Based on the IRS expert's testimony, the court held that the record supported reasonable

compensation of \$3,681,269 and \$1,362,831 for 2015 and 2016, respectively.

Note: Some jurisdictions apply an "independent investor" test. Under this alternative, the court asks whether an inactive, independent investor would have been willing to pay the amount of disputed compensation under the facts of the case.

### Shortcomings of the company's experts

Expert testimony focused on determining prevailing compensation rates for comparable positions at comparable businesses. Unfortunately, the court found the testimony of the company's two experts fell short.

Specifically, one expert wasn't sufficiently knowledgeable about the report he co-wrote with a colleague who didn't testify. The expert also "crudely" compared the business's performance with a multinational conglomerate without adjusting for "obvious and stark differences between such companies." In addition, he failed to provide supporting calculations or underlying data and incorrectly relied on the independent investor

test. The other expert's report relied on unsound assumptions and lacked supporting calculations and data.

In contrast, the IRS expert's report offered "the most credible and complete source of data, analyses, and conclusions" regarding what similar businesses might pay.

## Show your work

The Tax Court's application of the multifactor approach provides a useful guide to determining reasonable compensation in tax and other matters. It also demonstrates the importance of providing the calculations and data that support experts' conclusions. ■

# How to factor fraud risks into a business valuation

**C**urrent adverse market conditions could increase the motivation of dishonest workers to commit fraud — whether to meet their personal financial needs or to meet management's unrealistic financial goals. That's why it's imperative for businesses to step up efforts to deter and detect fraud. In addition, a company's fraud-reduction efforts may factor into its risk assessment — and ultimately affect its value.

## Assess fraud risks

When estimating value, it's important to identify potential risks and gauge whether management has taken appropriate action to mitigate those risks. Fraud can not only drain company resources, but also tarnish its reputation, lower morale, distract management, trigger regulatory actions — and even lead to bankruptcy in extreme instances. All else being equal, businesses with higher fraud risks warrant higher discount rates or lower pricing multiples, or both.

A strong system of internal controls is one of a company's most powerful fraud deterrents. Examples of internal controls include:

- ◆ Physical and digital controls (for example, locks, passwords, cameras and security systems),
- ◆ Fraud training programs,

- ◆ Job descriptions that call for segregation of duties and job rotation,
- ◆ Mandatory vacation policies,
- ◆ Background checks, and
- ◆ Whistleblower hotlines.

In addition, fraud risks can be reduced if the business's financial statements are audited by an outside accounting firm — or if the company's internal audit department conducts physical inventory counts or surprise audits of certain high-risk accounts during the year.

Together with strong internal controls, a vigilant corporate culture can make a big difference in deterring fraudulent acts. But neither provides an absolute guarantee against fraud.

## Ask the right questions

In addition to evaluating companies' internal controls and corporate cultures, valuation experts usually interview management to observe subtler clues. For example, they might inquire about the extent to which managers pressure subordinates at month- or year-end to meet goals. Or they might ask about previous fraud occurrences and how they were resolved. Careful, consistent handling

of fraud cases speaks volumes about management's attitude toward fraud risk.

When valuing a business, experts rely on information contained in the business's financial statements. To the extent that financial statements contain fraud, a valuator's conclusion will be inaccurate, unless properly adjusted.

## ID risky businesses

Every organization faces fraud risks, but some companies are statistically more vulnerable. For example, businesses with fewer than 100 employees tend to lack adequate fiscal and human resources. So, fraud strikes small, private businesses more frequently. In addition, their losses tend to be more costly and devastating over the long run, according to *Occupational Fraud 2022: A Report to the Nations*, a biennial publication of the Association of Certified Fraud Examiners (ACFE).

The most recent ACFE study also found that certain industries tend to incur higher fraud losses per incident than others. Industries that reported highest median losses in the 2022 study include real estate (\$435,000), wholesale trade (\$400,000), and transportation and warehousing (\$250,000). By comparison, the industry with the lowest median loss was food service and hospitality (\$55,000).



Valuators tailor their analyses of fraud risks based on the subject company's size, complexity, industry and goals. Such risk assessments predict where fraud may occur and whom the perpetrators might be, as well as the schemes fraudsters may engage in and how they might conceal their activities.

## Call in for reinforcements

Business valuations typically aren't designed to detect fraud. But experts need to be on the lookout for signs of fraud and, when necessary, adjust their analyses. Even if an expert is qualified to conduct both valuations and forensic accounting investigations, detecting and investigating fraud is outside the scope of traditional valuation assignments. When the red flags of fraud are spotted, consider expanding the scope of the engagement. ■

# Connecticut court determines fair value of 50% ownership interest

**F**air value in shareholder disputes is typically defined by state law. It generally equals fair market value without discounts for lack of control or marketability. In a 2022 case — *Buccieri v. New Hope Realty, Inc.* — the court addressed several important issues in determining the fair value of a 50% ownership interest in the context of a dissolution proceeding.

## No hope for New Hope Realty

The case involved a dispute between the trustees of the original founders of New Hope Realty (the plaintiffs) and the founders' two children (the defendants). The trust held 50% of the corporation's shares and the children owned the remainder. New Hope Realty, a real estate holding company,

owned property containing three commercial buildings. A shareholders' agreement provided that, in the event of a shareholder's death, the surviving shareholder would have a right of first refusal to buy any shares offered for sale by the decedent's estate or heirs at fair market value.

In 2020, the plaintiffs commenced a dissolution proceeding, alleging that the corporation was deadlocked. The defendants responded by filing a statutory election pursuant to Connecticut General Statutes Section 33-900 to buy the plaintiffs' shares. The parties were unable to agree on a price within 60 days, so the plaintiffs applied for a court determination of the shares' fair value.

### Experts weigh in

Each party offered expert testimony by a real estate appraiser and a business valuation professional. Both appraisers used the income capitalization and sales comparison approaches to determine the fair value of the real property, and both business valuers used the net asset value method to determine the stock's fair value. The plaintiffs' appraiser valued the real property at \$6.4 million. Their valuator, after adding other assets and subtracting liabilities, arrived at a fair value of the stock of about \$5.32 million (\$2.66 million for a 50% interest).

The defendants' experts valued the real property and stock at approximately \$4.65 million and \$3.53 million, respectively. The valuation expert went on to determine the stock's fair market value, applying a 10% discount for lack of control and a 20% discount for lack of marketability — ultimately reducing the value of a 50% interest to roughly \$1.27 million.

The court noted that Sec. 33-900 doesn't define "fair value." But the term is defined elsewhere in the state's statutes as excluding discounts.

### Court rejects discounts

The defendants took the position that the stock should be valued at

fair market value, arguing that the shareholders' agreement controlled the applicable standard. The court rejected this argument because the agreement wasn't triggered — none of the shares had been offered for sale. Instead, the court determined that Sec. 33-900, which governs the defendants' election to buy the shares, expressly calls for fair value. This statute is characteristic of most other state statutes regarding fair value.

The defendants also cited case law allowing discounts under extraordinary circumstances. In one case, for example, requiring payment of fair value would have imposed unrealistic financial demands on the company involved given its dire circumstances. In *Buccieri*, however, the court found that the defendants hadn't offered any evidence of extraordinary circumstances.

### Case facts matter

The court concluded that the plaintiffs' appraisal of the real property was too high, finding several of the appraiser's inputs and assumptions unreasonable. The court conducted its own valuation, determining that the fair value of the stock was approximately \$4.26 million — so the fair value of the plaintiffs' 50% interest was \$2.13 million.

Fair value is one of the gray areas in business valuation, and courts may sometimes interpret the law differently depending on case facts. Work closely with your business valuation expert to determine what's appropriate for the situation at hand. ■



# Business valuation, real estate appraisal — or both?

**E**very business needs real estate, whether it's commercial office space, a retail store, a manufacturing facility or a home office. If a valuation is needed, should you use a business valuation professional, a real estate appraiser or both? The answer depends on the relationship between the real estate and the business.

## Real estate holding companies

If the business being valued earns its revenue primarily from owning, selling or leasing commercial or residential real property, then a real estate appraiser will often be the primary valuation professional. However, a business valuator may be needed to assess the impact of the company's structure on value, especially when other (non-real estate) assets and liabilities are involved.

Suppose that a real estate holding firm is structured as a limited liability company. If a minority interest is being valued, a business valuator might calculate discounts for lack of control and lack of marketability.

## Hybrid businesses

On the other hand, if real estate is incidental to a business's operations, a valuator would likely take the lead. This may be the case, for example, if a company that produces or provides goods or services owns its facility or facilities, but the location or characteristics of the real estate aren't key factors in its financial performance.

If a business acquires real estate as an investment, whether a real estate appraiser is needed depends on the significance of the business's real estate holdings in relation to its overall value. Often, the value of non-real-estate businesses — such as retail shops, restaurants, hotels, marinas, cemeteries and golf courses — is tied to their location or the



special characteristics of their real property. This also may be true for hospitals or certain manufacturers that rely on specialized equipment, fixtures and structural accommodations that aren't readily moved or duplicated.

## Custom approach

In some cases, engaging *both* a real estate appraiser to determine the standalone value of the real property and a business valuator to determine a separate value for the business may produce more accurate results.

For instance, a real estate appraiser might be hired to determine the real property's fair market rental value. The business valuator might use that value to impute hypothetical rental expense to the business, reducing the company's earnings or cash flows for business valuation purposes, and arrive at a value for the company apart from the real estate. Then that value can be combined with the appraised value of the real estate to determine *total* enterprise value.

## It's complicated

Matters involving the valuation of businesses that own real estate tend to get complicated. Your business valuation experts can advise you on what's appropriate for your situation. ■



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