



# Be Reasonable

## HOW BUSINESS COMPENSATION CAN AFFECT DIVORCE CASES

By John W. Haag Sr.

### FAST FACTS

When a divorcing spouse owns or is a partner in a closely held business, the value of the business can play a significant role in the divorce case's financial outcome.

How owners' compensation is calculated can dramatically affect property settlements and support payments.

Retain a qualified valuator to assess any owner compensation that could affect the outcome of a divorce case.

**W**hen a divorcing spouse owns or is a partner in a closely held business, its value—particularly the total amount of compensation the business provides to its owners—can play a significant role in the divorce case's financial outcome. Whether you represent the business owner or his or her spouse, you will need a professional valuator to determine reasonable compensation.

### Voice of Reason

How owners' compensation is calculated can dramatically affect property settlements and support payments. For example, suppose Larry owns a construction company and decides to claim an excessive salary to reduce the business's value and, in turn, the amount of the property settlement. Or, in a different scenario, Larry claims an artificially low salary to reduce alimony and child support obligations.

Ideally, reasonable compensation for an owner of a closely held business like Larry's is the compensation he would be paid in an

arm's-length transaction for the services he performed. A valuation expert would, therefore, determine the amount that a hypothetical replacement employee would be paid to perform those same services. Reasonable compensation needs to reflect the services rendered and should not be confused with distributions of the business's earnings.

## Every Owner is Unique

Valuators weigh a variety of factors when determining reasonable compensation for a specific owner. Using the previous example, experts would look at five factors regarding the owner:

- (1) **Role in the business:** It is essential to look beyond a job title. A law firm, for example, may employ numerous partners, but they do not all fill the same roles. Some are rainmakers while others fight in the litigation trenches or manage the firm's operations. A valuator considers the experience and qualifications necessary to fill the partner's specific job as opposed to simply the qualifications the partner happens to possess.
- (2) **Compensation relative to comparable positions:** The compensation received by similarly situated employees at similar companies is often useful. Valuators gather such data from a growing collection of sources including the Bureau of Labor Statistics, the Medical Group Management Association, the Economic Research Institute, and professional associations.
- (3) **Company's internal consistency:** How does the owner's or partner's compensation compare with that of the business's non-owner employees? If the business consistently pays below-market rates for other employees, an above-market rate for an owner may be unreasonable.
- (4) **Business characteristics and condition:** The business's size, complexities, industry, competitive position, financial condition, and history all bear on the reasonableness of compensation. Companies with a long record of high revenues from loyal customers generally can afford to pay high compensation, but smaller companies might pay a significant salary premium to woo those same employees.
- (5) **Business location:** A technology-based firm located in an urban area will probably have greater access to comparable employees than a similar company in a rural area. The cost of living is relevant, too. An owner in San Francisco requires more compensation than an owner in Anchorage to maintain a similar standard of living.

## Professional Practices Require More

When determining reasonable compensation for a partner in a professional practice, valuators consider some basic variables,

## Poking Holes in Compensation Testimony

Not all testimony carries equal authority. Whether preparing your own experts or working to challenge opposing experts, consider issues that will affect the credibility of their testimony on reasonable compensation, including:

- The source of data used to form the expert's opinion
- Whether the data has a regional or national scope
- The sampling sizes
- Whether the data provides means or medians
- Whether the data includes owners whose compensation is made up of both straight compensation and business profits
- How the data defines job titles—whether the duties used in the definition are sufficiently similar to those of the spouse
- How the data defines the companies—whether the company characteristics used in the definition are sufficiently similar to those of the company in the case
- Whether the data includes stock compensation and other perks

including the type of professional services offered or specialty, and the duration of the partner's practice. Other factors might include:

- Age and health of the partner
- Hours worked and general productivity
- Practice's market
- Number of locations in which the practice operates

Management or administrative responsibilities handled by the practice partner will help to determine reasonable compensation.

## Reasonable Doubt

Remember that what might appear reasonable may turn out to be anything but. Retain a qualified valuator to assess any owner compensation that could affect the outcome of a divorce case. ■



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