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Compensation Issues Complicate Valuations in Divorce Cases

In a divorce that involves a closely held business as one of the marital assets, determining the accurate value of the business is a key first step in determining the equitable distribution of marital assets between the parting spouses. An issue that frequently complicates that valuation is the question of reasonable compensation.

For a variety of reasons, closely held companies often have executive pay packages that offer above-market salaries and benefits, especially for owners. In the case of C corporations, the Internal Revenue Service may examine these packages to determine whether they have been allocated properly among salaries (which are deductible to the company, thus avoiding double taxation) and dividends. A valuation professional, however, takes a different view.

Above Market?

From a valuation perspective, the question is whether the pay package is above market. A valuation is based on a hypothetical transaction involving a willing buyer and willing seller.

Therefore, the valuation professional must determine what compensation such a buyer would have to pay to a non-owner to attract a qualified person to perform duties similar to those performed by the party receiving the pay package in question.

If the owner's pay is above market, the valuation professional then makes an adjustment, treating the above-market portion of that compensation as return on investment instead of as compensation. This increases the value of the company.

In measuring the owner's total compensation, the valuation professional must be sure to look not only at salary, but also at benefit programs; equity compensation, such as stock options; bonuses; and fringe benefits.

Valuation professionals can draw on a variety of data sources to compare an owner's compensation with the current market. They can look at the 10Qs and 10Ks filed by public companies of similar size and in similar industries.

The Economic Research Institute offers an Executive Compensation Assessor that

can be searched by SIC code, geographic location, size, and market capitalization.

Another excellent data source is the compensation that the subject company pays to its current non-owner employees, taking into consideration the differences in roles and responsibilities.

With compensation data from appropriate entities in hand, the valuation professional then must make certain subjective judgments based on the owner's experience and knowledge in the market, technical or other specialized skills, customer and other key relationships, and so forth.

Double Dipping

In a divorce where the value of a closely held business is adjusted because of compensation, the affected parties should guard against a situation where the spouse who is not involved in the business "double dips." Here's how that can happen.

Suppose a divorcing husband owns a business and has been taking a well-above-market salary for years. The value of the business is adjusted upwards to reflect that salary, and the husband then has to pay the wife for her share of the business's now-higher value.

Now, suppose the husband also must pay spousal support. As is often the case, that support is based on the husband's previous earnings. The result? The wife collects her share of the business's value based on lower earnings, while simultaneously collecting spousal support based on higher earnings.

Clearly, a number of valuation issues can come into play in a divorce involving a business. Integrating effective valuation advice into divorce representation is vital.