

Unified Court System Judicial Training Program

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Calculating Income & Executive Compensation

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Sources of Income

- Employee (Executive Compensation)
 - Base salary
 - Bonus
 - Perquisites
 - Incentives
- Business Owner
 - Compensation for services
 - Income in excess of compensation for services

Executive Compensation

- Perquisites versus Incentives
 - Employment agreement is a perquisite
 - Stock option plan is an incentive
- Private vs. Public Company
 - Average private corp. CEO = \$378k
 - Average for S&P 500 = \$12 million
 - Per Salary.com median CEO salary is \$749k and \$1.164 million w/ bonus
- Benchmarking
 - Executive Compensation Survey
 - Payscale.com
 - Salary.com
 - Economic Research Institute



Executive Perquisites (Fringe Benefits)

- Provided to executives and not to other employees
 - Annual physical & supplemental medical coverage
 - Company car or other car allowance
 - First class air travel
 - Club memberships
 - Corporate credit cards
 - Housing allowance
 - Spousal travel allowance
 - Supplemental life insurance and disability programs
 - Supplemental executive retirement plans (SERPS)
 - Voluntary deferred compensation



Internal Revenue Code (IRC)

- Amended to include the term “fringe benefits” in the definition of gross income
- A fringe benefit provided in connection with the performance of services is includible in gross income (IRC §61)
- Only specifically excluded fringes are not taxable (IRC §132) such as de minimis fringes, qualified employee discounts and qualified moving expenses
- Even though taxable, employers may not treat them as wages for income and employment taxes
 - Use of expense reports, corporate credit cards, loans



Incentive Compensation

- Bonuses
- Stock Options
- Phantom Stock
- Restricted Stock
- Stock Appreciation Rights

Bonus Allocation

- Compensation for past services
- Normally not an issue

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Bonus	03/01/15				

Stock Options

- Contract that allows the executive to purchase company stock at a fixed price after a specified vesting period
- “Qualified” Stock Options (Incentive Stock Options or ISOs)
 - Generally not taxed when granted or exercised
 - Not subject to employment taxes
 - Tax is imposed when stock is sold and at long-term capital gains rates as long as certain holding requirements are met
- “Non-Qualified” Stock Options (NQOs)
 - Taxed when exercised at ordinary income t
 - Subject to employment taxes



Internal Revenue Code

- IRS has concluded that the transfer of vested options pursuant to a divorce is not taxable under IRC §1041 (Revenue Ruling 2002-22)
- May not apply to unvested options

Marital Options

- Generally, vested options that were granted during the marriage are entirely marital
- However, options that were granted during the marriage but will not vest until after the divorce can be problematic
- Prior to *DeJesus v. DeJesus*, we took the position that unvested options were not part of the marital estate

DeJesus Coverture Fraction

- Past Services

Later of Date of Employment or Date of Marriage to Date of Grant
Date of Employment to Date of Grant

- Future Services

Date of Grant to Date of Commencement
Date of Grant to Date of Vesting

Phantom Stock

- Promise to pay a bonus equivalent to the value of the company's stock
- Taxed like any other cash bonus and subject to employment taxes

Restricted Stock

- Grant of company stock in which the recipient's rights in the stock are restricted until vesting and/or until the restriction period ends
- See SEC Rule 144; restricted stock not transferrable for a defined period of time—used to be two years, now 6 months
- No tax at time of grant but fully taxable at vesting at ordinary income tax rates and subject to employment taxes; tax based on fair market value of the stock at that time
- Note there is no exercise cost so the entire value of the stock is taxable at the time of vesting
- Under IRC §83(b), executive can elect to include the FMV of the RSU at the date of grant regardless of the restriction—not subject to tax when the shares vest no matter what the value; receive capital gains treatment upon sale.



Stock Appreciation Rights (SARs)

- Much like a phantom stock
- Provides the monetary equivalent of the increase in value of a specified number of shares over a specified period of time
- Taxed at ordinary income rates including employment taxes at the time of exercise.

Disclosure for Public Companies

- For public companies, the SEC requires clear and concise disclosure about compensation paid to CEOs, CFOs and other high ranking executives
- Required in annual proxy statement and annual report on 10-K
- The Summary Compensation Table is the cornerstone of the SEC's required disclosure on executive compensation; sets out in a single location a comprehensive overview of a company's executive pay practices to include all perquisites and incentive based plans.



Disclosure for Private Companies

- For private companies, no such disclosure rules exist
- Owner compensation can be disguised as other business deductions or buried using other schemes that are originally designed to underreport income and ultimately pay less taxes

“Normalized” Income

- A reasonable amount of compensation for the services provided by the owner/executive, plus
- Income in excess of reasonable and necessary operating expenses including reasonable owner compensation
- This is typically referred to as normalized income

Available income	\$ 500,000
Replacement compensation	<u>(250,000)</u>
Normalized income	<u><u>\$ 250,000</u></u>



Forensic Procedures (Expenses)

- General Ledger Analysis
 - Records all the activity within each account that makes up the balance sheet and income statement
 - Electronic versus paper
 - QuickBooks and Peachtree
 - Rights to electronic discovery
 - Verification of general ledger activity using third party vendor invoices
- Credit Card Analysis
- Payroll Ledger Analysis
- Benchmarking



Forensic Procedures (Revenues)

- More Difficult and Time Consuming
- Cash Businesses – e.g. restaurants, bars, liquor stores, car washes
- Use of Cash Register Tapes and Other Point of Sale records
- Mark Up Test
 - Product costs may also be manipulated
 - Using ancillary products like pizza boxes
- Example Car Wash
 - Observations
 - Industry Statistics
 - Water Bills
 - Traffic Counts

Lifestyle Analysis

- Developing an estimate of income through an analysis of personal expenses
- Typically includes estimating certain expenses that might be paid in cash; e.g. groceries, gas, nanny, vacations, etc.
- Time consuming and expensive
- Controversy exists as to whether or not a lifestyle analysis can be conducted by the court appointed accountant as part of a Court Order to conduct an income analysis

Non-Cash Expenses

- Depreciation
 - When major equipment is purchased, it is capitalized and recorded as an asset on the balance sheet as opposed to expensed and recorded as an expense on the income statement
 - Depreciation is a non-cash expense that prorates the cost of an asset over its estimated useful life
 - Allowed under GAAP and for income tax reporting
 - For income taxes certain accelerated depreciation is allowed
 - Under §179 of the IRC, a business can deduct \$500,000 of capital expenditures in a single year
 - For valuation and support purposes, this must be identified and adjusted to what is referred to as straight-line depreciation

Non-Cash Expenses

- Amortization
 - Refers to spreading an intangible asset's cost over its useful life
 - Goodwill, customer lists, patents
- Depletion
 - Refers to the allocation of the cost of natural resources
 - Oil wells

Shareholder Loans

- Loans vs. Dividends
 - IRC provides that a distribution from a C-corporation to a shareholder is a taxable dividend to the extent of the corporations earnings and profits
 - Whether a withdrawal is a taxable dividend depends on whether or not there was an intent to repay the amounts received and if the corporation intended to require repayment
 - Is there a promissory note, repayment schedule, interest rate charged and history of repayments?

Loan vs. Dividend

- Factors Used by the Courts
 - The extent to which shareholder controls the corporation
 - The earnings and dividend history
 - The size of the advances
 - Whether security was given for the loan
 - Whether there was a set maturity date and repayment schedule
 - Written evidence of the loan such as an interest-bearing note
 - Whether the corporation took steps to enforce repayment
 - Whether the shareholder was in a position to repay the loan
 - Whether there was any indication of attempts by the shareholder to repay the loan



Phantom Income

Revenues	\$ 1,250,000
Owner compensation	250,000
Other expenses	<u>750,000</u>
Business income	250,000
Working capital needs	<u>50,000</u>
Distributions	<u><u>\$ 200,000</u></u>

Example

Income as reported	\$ 100,000
Owner compensation	75,000
Section 179 depreciation	500,000
SLM Depreciation	(100,000)
Rent	85,000
FMV Rent	(45,000)
Lexus lease	7,200
Auto insurance	2,400
Wife's automobile	5,200
Auto insurance	2,000
Auto maintenance	4,500
Meals & entertainment	15,000
Continuing education	24,000
Trade journals	1,500
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Income Available to Owner	<u>\$ 676,800</u>



Income & Executive Compensation

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