Analysis of Reasonable Compensation for Unique Companies or Unique Employees

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Discussion Outline

- Reasons to conduct a reasonableness of compensation analysis
- Alternative standards by which to determine reasonableness of compensation
- Two categories of reasonableness of compensation analysis
- Multiple factor test analyses
- Independent investor test analyses
- Considerations in a reasonableness of compensation analysis
- Multiple factor test illustrative example
- Independent investor test illustrative example
- Reasonableness of compensation analysis caveats
- Summary and conclusion, questions and discussion

Reasons to Conduct the Reasonableness of Compensation Analysis

- More obvious reasons
  1. Income normalization adjustment—when valuing a controlling ownership interest in a business or professional practice
  2. C corporation – shareholder/employee compensation too high

     S corporation – shareholder/employee compensation too low
  3. Family law – too high compensation causes understated business value

     – too low compensation causes understated alimony

Reasons to Conduct the Reasonableness of Compensation Analysis (cont.)

- Less obvious reasons
  1. Shareholder litigation
     - shareholder oppression – too high compensation results in understated dividends and capital gains
     - dissenting shareholder appraisal rights – too high compensation results in understated fair value of stock
  2. Tort litigation
     - breach of fiduciary duty claims
     - dissipation of corporate assets claims
  3. Breach of contract ligation
     - breach of joint venture agreement
     - breach of partnership agreement

Reasons to Conduct the Reasonableness of Compensation Analysis (cont.)

- Less obvious reasons (cont.)
  4. Not-for-profit entity concerns
     - private inurement and excess benefits related to excess physician/executive compensation
     - Medicare fraud and abuse
  5. ESOP/ERISA litigation
     - claims against trustee for allowing excess compensation
  6. Private equity fund (or other investor) negotiation of the terms of the private company investment

Tax Deduction for Employee/Shareholder Compensation

- IRC Section 162(a)(1) allows a deduction for compensation that is “a reasonable allowance for salaries or other compensation for personal sources actually rendered”
- The four requirements for an employee compensation deduction described in Regulation 1.162-7 are:
  1. an ordinary and necessary expense,
  2. reasonable in amount,
  3. based on services actually rendered, and
  4. actually paid or incurred by the taxpayer corporation.

Tax Deduction for Employee/Shareholder Compensation (cont.)

- According to Regulations 1.162-7 and 1.1032-1, a taxpayer corporation may deduct a shareholder/executive compensation payment that is based on a percentage formula. The percentage formula may be:
  - a percent of corporation revenue,
  - a percent of corporation earnings, or
  - a percent of some of corporation income measure.
- However, the formula-based compensation payments should be:
  - reasonable in amount,
  - based on services actually performed, and
  - paid or incurred in the year in which the deduction is claimed.

Considerations in the Reasonable Compensation Analysis

- What is meant by reasonable compensation?
  - maximum supportable level of compensation?
  - greater than mean or median?
  - greater than 75th percentile?
  - greater than 90th, 95th, 98th percentile?
- Tie the quantitative analysis into the "story" of the employee's performance
- Describe why superior company performance is due to the employee and not due to:
  - favorable market conditions
  - competitors' failures
  - intangible assets and intellectual property
  - being in the right place at the right time

Considerations in the Reasonable Compensation Analysis (cont.)

- What are comparable companies?
  - same SIC code
  - same size – revenue, profits, assets, equity
  - same income tax status
  - same criteria as used to select BV comparable companies
- When analyzing comparable companies, consider all forms of executive compensation
  - salary and bonus
  - stock and stock options
  - use of company assets
  - other employee benefits
- What are “comparable employees” at “comparable companies”?

Considerations in the Reasonable Compensation Analysis (cont.)

- When analyzing comparable executives at comparable companies, remember that private company executive titles may not be comparable to public company executive titles
- Touch all the bases (consider all the factors) in whatever multiple factor test you select
- For tax-related compensation disputes, consider what alternative judicial jurisdictions are available to the taxpayer

Additional Factors to Consider in Analysis of Shareholder/Employee Compensation

- Personal guarantee for company debt
- Personal guarantee for company leases
- Personal guarantee for company contracts
- Also serves on board of directors
- Also serves as trustee for the company retirement plan
- Often, shareholder/executive is the last person to be paid salary and/or bonus

Reasonable Compensation versus Ownership Control Adjustments

- Don't confuse (or double count) excess compensation adjustments with other ownership control normalization adjustments:
  - company paid vacations
  - company paid club dues
  - use of company assets (car, plane, homes)
  - lease of related party assets
  - phantom employees
  - debt to/from the company
  - company-paid personal expenses
  - other

Illustrative Multi-Factor Test
Judicial Precedent

- *Mayson Manufacturing Co.*
  178 F.2d 115 (6th Cir. 1949)
  (factors also included in the *Internal Revenue Manual*)
- *Elliotts, Inc.*
  716 F.2d 1241 (9th Cir. 1983)
- *Trucks, Inc. v. U.S.*
  588 F. Supp. 638 (D.C. Neb. 1984)
- *Pulsar Components International, Inc.*
  TCM 1996-129

Illustrative Independent Investor Test Judicial Precedent

- Exacto Spring Corp. v. Commissioner
  196 F.3d 833 (7th Cir. 1999)
- Menard Inc.
  560 F.3d 620 (7th Cir. 2009)

Excess Benefit and Private Inurement Judicial Precedent

- *People ex rel. Spitzer v. Grasso*
  - 2006 WL 3016952 (NY sup)
  - NYSE CEO
- *Vacco v. Diamandopoulos*
  - 185 Misc 2d 7294 (NY sup 1998)
  - Adelphi University president
- non-litigated AG investigation of Harvard University endowment fund manager
- non-litigated AG investigation of American University president
- non-litigated AG investigation of J. Paul Getty Trust president
- non-litigated IRS investigation of The Nature Conservatory president
- audits by IRS, state attorneys general, Office of Inspector General (for healthcare entities), and other regulatory authorities

Mayson Manufacturing Co. Multi-Factor Test

- The eight *Mayson* multi-factor tests follow:
  1. the employee's particular qualifications for the job,
  2. the nature, scope, and extent of the work actually performed by the employee,
  3. the size and complexity of the subject business enterprise,
  4. the economic conditions and background of the industry involved,
  5. the subject company's dividend history
  6. comparable salaries paid in the industry,
  7. the compensation paid to the subject company's other employees, and
  8. the subject employee prior years' compensation (especially for years in which the employee was clearly undercompensated).

Mayson Manufacturing Co., 178 F.2d 115 (6th Cir. 1949)

Elliotts and Multi-Pak Multi-Factor Test

- The *Elliotts, Inc.* (and the *Multi-Pak Corp.*) five reasonableness of compensation factors follow:
  1. the employee's role in the subject corporation,
  2. an external comparison with other comparable companies,
  3. the character and the condition of the subject corporation,
  4. any potential conflicts of interest, and
  5. the internal consistency of executive compensation practices within the subject corporation.

Elliotts, Inc., 716 F.2d 1241 (9th Cir. 1983)

The *Trucks, Inc.* Multi-Factor Test

- The *Trucks, Inc. v. U.S.* multi-factor tests follow:
  1. employee qualifications and training
  2. nature, extent, and scope of employee duties
  3. responsibilities and number of hours involved
  4. size and complexity of the subject business
  5. results of the employee's efforts
  6. prevailing rates for comparable employees in comparable businesses
  7. ratio of compensation to company growth and net income (measured before salaries and tax)
  8. absence of usual fringe benefits (pension or profit-sharing plan, stock options, etc.), which are available to executives of other companies of comparable size
  9. employee's responsibility for the company's inception and/or success
  10. time of year the compensation was determined and by whom

The *Trucks, Inc.* Multi-Factor Test (cont.)

- The *Trucks, Inc. v. U.S.* multi-factor tests follow: (cont.)
  11. correlation between the shareholder/executive compensation and his/her ownership interest
  12. the corporation's dividend history
  13. prevailing economic conditions
  14. examination of the financial condition of the subject company after paying the compensation
  15. whether an independent investor would be willing to compensate the shareholder/executive at the amount that he/she was compensated

Trucks, Inc. v. U.S. 588 F.Supp. 638 (D.C. Neb. 1984)

Pulsar Components International, Inc. Multi-Factor Tests

- The *Pulsar Components International, Inc.* multi-factor tests follow:
  1. the employee's qualifications
  2. the nature, extent, and scope of the employee's work
  3. the size and complexities of the employer's business
  4. a comparison of salaries paid with the employer's gross and net income
  5. the prevailing general economic conditions
  6. a comparison of salaries with distributions to officers and retained earnings
  7. the prevailing rates of compensation for comparable positions in comparable concerns
  8. the salary policy of the employer as to all employees
  9. the compensation paid to the particular employee in previous years the employer's financial condition
  10. whether the employer and the employee dealt at arm's-length

Pulsar Components International, Inc. Multi-Factor Tests (cont.)

- The *Pulsar Components International, Inc.* multi-factor tests follow: (cont.)

  11. whether the employee guaranteed the employer's debt
  12. whether the employer offered a pension plan or profit sharing plan to its employees
  13. whether the employee was reimbursed by the employer for business expenses that the employee paid personally

Pulsar Components International, Inc., TCM 1996-129

General Sources of Executive Compensation

- Subscription-Based Sources
  - Compdata Surveys, Dolan Technologies, Corp., www.compdatasurveys.com
  - Compensation.BLR.com, Business & Legal Resources, www.blr.com
  - CompQuest Online, Towers Watson Data Sources, www.twdataservices.com
  - EquilarInsight, Equilar, Inc., www.equilar.com
  - Executive Compensation Assessor, Economic Research Institute, www.erieri.com
  - Kenexa CompAnalyst Executive, Kenexa, Inc., www.kenexa.com

General Sources of Executive Compensation (cont.)

- Free or Inexpensive Sources
  - America's Career InfoNet, Career One Stop (sponsored by the US Department of Labor), www.CareerInfoNet.org
  - eStatement Studies, RMA, Inc., www.rmahq.org/tools-publications/tools/estatement-studies
  - Occupational Employment Statistics—Wages by Area and Occupation, Bureau of Labor Statistics, U.S. Department of Labor, www.bls.gov/oes/
  - Officer Compensation Data, Integra Information, www.microbilt.com/industry-statistical-data.aspx
  - Salary.com for Business, Salary.com, www.salary.com

Selected Healthcare Compensation Sources

- *AAMC Data Book: Medical Schools and Teaching Hospitals by the Numbers*, Association of American Medical Colleges, annual. Contains a section on total compensation attributable to teaching, patient care, and research for full-time faculty at accredited medical schools.
- *Academic Practice Compensation and Production Survey for Faculty and Management*, Medical Group Management Association, annual. Provides compensation and productivity information for full-time equivalent faculty physicians and nonphysician providers and compensation for executives and middle managers employed at academic medical centers and teaching hospitals.
- *Hospital Salary & Benefits Report*, Hospital & Healthcare Compensation Service, annual. Provides salaries and bonuses for 179 hospital positions including management, nursing, therapy, laboratory, radiological, rehabilitation, dietary, pharmacy, technical, and clerical.

Selected Healthcare Compensation Sources (cont.)

- *Management Compensation Survey*, Medical Group Management Association, annual. Provides annual compensation and benefit information for physician executives, executive management, senior management, general management, specialists, and supervisors within a medical group practice environment.
- *Medical Group Compensation and Financial Survey*, American Medical Group Association, annual. Provides compensation and productivity data for various medical specialties for physicians, nonphysician providers, and administrative staff.
- *MGMA Physician Compensation and Production Survey*, Medical Group Management Association, annual. Provides ranges of compensation and productivity for both full-time equivalent physicians and nonphysician providers.

Selected Healthcare Compensation Sources (cont.)

- *Physician Salary & Benefits Report*, Hospital & Healthcare Compensation Service, annual. Provides total compensation for staff physicians in medical practices and at hospitals.

Illustrative Example of ERI Executive Compensation Assessor

- Illustrative fact set: Pharmaceutical company CEO
- Industry SIC or NAICS code: SIC code 2830
- Area: Chicago, Illinois
- Organization size (revenue): $4,000,000,000
- Planning date (can be historical): September 30, 2012
- Position: CEO
- It is possible to select the mean or median. The percentiles can also be changed. The lowest percentile is 10% and the highest percentile is 90%.

ERI Data Example

EXECUTIVE COMPENSATION ASSESSOR

Position Description

Chief Executive Officer

Chief Executive Officer

Alternate Titles
CEO; Chairman of the Board & CEO; Executive Director CEO; President; Top Executive; Top Executive Officer; Top Group Executive

Overview
Plans, develops, establishes, and oversees interpretation and implementation of policies and objectives of organization in accordance with board directives and corporation charter.

Typical Functions
Responsible for the profitability of the entire organization.

Holds position of the top executive and principal organization leader in the organization.

This position is distinguished from others in that it is the top ranking executive and, in most cases, is the highest paid executive in the organization.

Confers with organization officials to plan business objectives, to develop organizational policies to coordinate functions and operations between divisions and departments, and to establish responsibilities and procedures for attaining objectives.

Reviews activity reports and financial statements to determine progress and status in attaining objectives and revises objectives and plans in accordance with current conditions.

Directs and coordinates formulation of financial programs to provide funding for new or continuing operations to maximize returns on investments, and to increase productivity.

Plans and develops industrial, labor, and public relations policies designed to improve company's image and relations with customers, employees, stockholders, and public.

Evaluates performance of executives for compliance with established policies and objectives of firm and contributions in attaining objectives.

May preside over Board of Directors.

May serve as chairman of committees, such as management, executive, engineering, and sales.

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ERI Data Example (cont.)

EXECUTIVE COMPENSATION ASSESSOR

Individual Position Profile

Chief Executive Officer

Estimated Survey Median Annual Base Salaries			
Revenue	25th Percentile	Survey Median	75th Percentile
4,000,000,000	969,616	1,264,868	1,648,743
3,800,000,000	958,106	1,249,845	1,629,151
3,500,000,000	939,871	1,226,044	1,598,112

Specifications

Prepared For:

Area: **Chicago, Illinois**

Industry: **Pharmaceuticals**
Industry Codes: **eSIC: 2830, NAICS: 325400, usSEC: 2833**
Organization Size: **4,000,000,000 (Revenue)**

Planning Date: **September 27, 2012**
Database as of: **July 1, 2012**

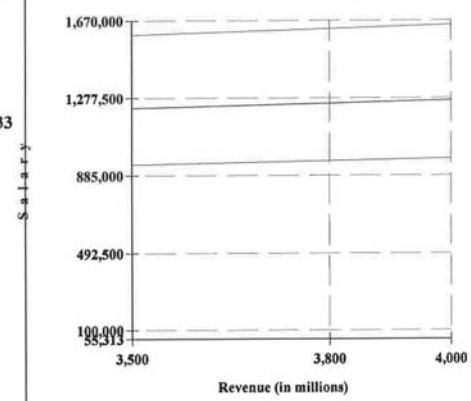
Annualized Salary Trend: (unavailable)

eDOT: 189.117-026
O*Net/SOC: 111011

Printout Date: September 27, 2012
ERIXA File:

(items in bold affect salary estimates)

Annual Base Salaries Graph



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ERI Data Example (cont.)

EXECUTIVE COMPENSATION ASSESSOR

Individual Position Profile

Chief Executive Officer

Estimated Survey Median Annual Total Compensation			
Revenue	25th Percentile	Survey Median	75th Percentile
4,000,000,000	1,738,918	2,269,102	2,958,610
3,800,000,000	1,711,706	2,233,576	2,912,265
3,500,000,000	1,668,795	2,177,555	2,839,182

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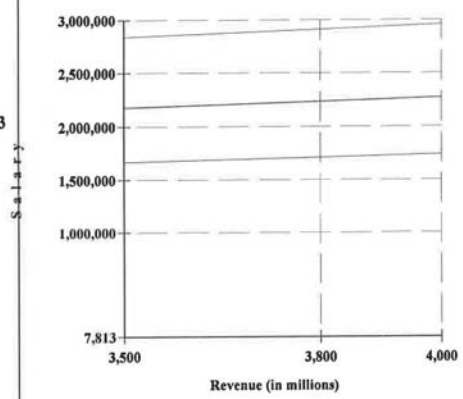
Annual Total Compensation Graph



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Illustrative Presentation to the Alpha Institute of Medical Research Compensation Committee October 1, 2012

Reasonableness of Compensation

Paid to Certain Senior Executives

Reasonableness of Executive Compensation Analysis – Objective of the Analysis

- We performed an analysis to conclude the reasonableness of executive compensation paid to certain executives by the Alpha Institute of Medical Research ("Alpha").
- We analyzed the compensation paid to the following executives:
  - Benjamin Beta ("Mr. Beta") is the Alpha chief executive officer and chairman of the board.
  - Gary Gamma, M.D. ("Dr. Gamma") is the Alpha president and chief operating officer. He is also responsible for, and has full authority and control of, the Alpha discovery and development operations.
  - David Delta ("Mr. Delta") is the Alpha executive vice president and chief financial officer.
  - Edward Epsilon, Esq. ("Mr. Epsilon") is the Alpha chief legal officer.
  - Zachariah Zeta, Ph.D. ("Dr. Zeta) is the Alpha scientific director.

Reasonableness of Executive Compensation Analysis – Purpose of the Analysis

- Tax-exempt organizations, as defined in Section 501(c)(3), are prohibited from providing private inurement (that is, giving excess benefits to private individuals). Section 4958 defines an excess benefit transaction as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."
- Prohibited transactions for tax-exempt organizations, as defined in Section 503, include payment of compensation "in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered."

Reasonableness of Executive Compensation Analysis – Purpose of the Analysis (cont.)

- For for-profit organizations, Regulation 1.162-7(b)(3) defines reasonable compensation as "such amount as would ordinarily be paid for like services by like enterprises under like circumstances."
- For purposes of this analysis, reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises under like circumstances, not exceeding the value of the personal services rendered.

Reasonableness of Executive Compensation Analysis – Framework and Relevant Factors

- The *Internal Revenue Manual* lists the factors that the Service considers in its determination of the reasonableness of executive compensation, for both for-profit entities and not-for-profit entities.
- The *Internal Revenue Manual* factors are often referred to as the *Mayson* factors, because they were first listed in *Mayson Mfg. Co. v. Commissioner,* 178 F.2d 115, 119 (6th Cir. 1949).

Reasonableness of Executive Compensation Analysis – Three Benchmark Analyses

- Analysts typically use the following three benchmark analyses to estimate reasonable compensation for not-for-profit entity executives:
  - a salary survey analysis,
  - a proxy statement analysis, and
  - a financial ratio analysis.
- Salary Survey Analysis
  - First, we estimated a range of reasonable compensation by reference to published executive compensation survey data. We relied on the following two executive compensation surveys:
    - Economic Research Institute (ERI)
    - Towers Watson Data Services
  - However, these two surveys do not include any non-cash compensation, such as awards of stock or stock options.
  - In order to provide a compensation package that is competitive with what executives could earn at for-profit organizations, Alpha will have to offer higher levels of cash compensation.

Reasonableness of Executive Compensation Analysis – Three Benchmark Analyses (cont.)

- Proxy Statement Analysis
  - Second, we performed an analysis of compensation, including the value of stock awards and stock options granted, paid by public companies in health-related industries. These compensation amounts are reported on proxy statements or other SEC documents.

Reasonableness of Executive Compensation Analysis – Three Benchmark Analyses (cont.)

- Financial Ratio Analysis
  - Third, we calculated the ratios of (1) total officer/director compensation to year end fund balance and (2) total officer/director compensation to beginning of year total assets for not-for-profit health-related and medical organizations. We applied these ratios to the Alpha fund balance and the Alpha total assets.
  - Next, we subtracted the compensation paid to the Alpha officers/directors (other than each subject executive) in order to estimate the reasonableness of compensation paid to each executive.
  - This analysis estimates the amount of compensation "available" to pay to each executive while keeping the total amount of officer/director compensation within a reasonable range.

Reasonableness of Executive Compensation Analysis – Three Benchmark Analyses (cont.)

- We did not assign specific weight to the third analysis in our final conclusion.
- The financial ratio analysis confirmed that the amount of compensation concluded from (1) the salary surveys and (2) the public company proxy statements fell within a reasonable range.

Salary Survey Analysis – Benjamin Beta

ERI Executive Compensation Assessor for Chairman of the Board and Chief Executive Officer

Industry Description	Revenue $	Median Compensation $	75th Percentile Compensation $	85th Percentile Compensation $
Pharmaceuticals	2,000,000,000	1,726,945	2,251,770	2,529,542
General Medical and Surgical Hospitals	2,000,000,000	1,187,832	1,680,086	1,940,620
Medical Laboratories	2,000,000,000	1,203,270	1,701,921	1,965,842
Research, Development, and Testing	2,000,000,000	1,420,324	1,940,257	2,215,440
Pharmaceuticals	1,500,000,000	1,575,365	2,054,124	2,307,516
General Medical and Surgical Hospitals	1,500,000,000	1,085,219	1,534,949	1,772,977
Medical Laboratories	1,500,000,000	1,097,947	1,552,951	1,793,770
Research, Development, and Testing	1,500,000,000	1,289,488	1,761,526	2,011,360
Pharmaceuticals	1,000,000,000	1,384,468	1,805,213	2,027,900
General Medical and Surgical Hospitals	1,000,000,000	955,888	1,352,021	1,561,682
Medical Laboratories	1,000,000,000	965,979	1,366,294	1,578,168
Research, Development, and Testing	1,000,000,000	1,125,896	1,538,047	1,756,186
Pharmaceuticals	500,000,000	1,114,741	1,453,515	1,632,817
General Medical and Surgical Hospitals	500,000,000	772,705	1,092,925	1,262,408
Medical Laboratories	500,000,000	780,609	1,104,104	1,275,320
Research, Development, and Testing	500,000,000	897,382	1,225,883	1,399,748

Towers Watson Compensation Regression Analysis for Chief Executive Officer

Industry Description	Revenue $	Mean Compensation $	75th Percentile Compensation $	84th Percentile Compensation $
All Organizations (excluding financial services)	2,000,000,000	1,357,026	1,992,461	2,397,186
High Technology	2,000,000,000	1,382,535	1,893,580	2,203,218
Health Care	2,000,000,000	1,516,021	2,004,790	2,293,524
Engineering Services	2,000,000,000	1,293,578	1,803,108	2,115,755
All Organizations (excluding financial services)	1,500,000,000	1,252,724	1,839,318	2,212,936
High Technology	1,500,000,000	1,266,762	1,735,011	2,018,720
Health Care	1,500,000,000	1,402,319	1,854,430	2,121,509
Engineering Services	1,500,000,000	1,226,532	1,709,653	2,006,096
All Organizations (excluding financial services)	1,000,000,000	1,119,185	1,643,250	1,977,040
High Technology	1,000,000,000	1,119,858	1,533,806	1,784,614
Health Care	1,000,000,000	1,256,395	1,661,459	1,900,746
Engineering Services	1,000,000,000	1,137,894	1,586,102	1,861,122
All Organizations (excluding financial services)	500,000,000	923,029	1,355,243	1,630,531
High Technology	500,000,000	907,089	1,242,388	1,445,544
Health Care	500,000,000	1,041,231	1,376,926	1,575,234
Engineering Services	500,000,000	1,000,948	1,395,213	1,637,134

Indicated Range of Reasonable Annual Compensation Levels

Salary Survey Analysis	Range of Annual Compensation [a] Low $	High $	Average $
ERI Executive Compensation Assessor	955,888	2,307,516	1,631,702
Towers Watson Regression Analysis	1,119,185	2,212,936	1,666,061

Proxy Statement Analysis – Benjamin Beta

Guideline Company Size	Number of Guideline Companies	Total Compensation Excluding Stock Options: Median Compen-sation $	25th Percentile Compen-sation $	75th Percentile Compen-sation $	84th Percentile Compen-sation $	Average Compen-sation $	Executives Receiving Option Awards %	Average Value of Option Awards $
Companies with $3.5 Billion in Assets - $10 Billion in Assets	16	6,469,537	4,623,484	7,940,983	8,550,719	6,214,968	50.0%	1,893,767
Companies with $800 Million in Assets - $3.5 Billion in Assets	23	2,911,174	2,129,020	4,414,061	5,934,264	3,771,740	82.6%	3,107,879
Companies with $500 Million in Assets - $800 Million in Assets	11	1,583,158	917,910	1,993,104	2,199,257	1,509,846	45.5%	813,173

Indicated Range of Reasonable Annual Compensation [a]			
Type of Compensation	Low $	High $	Average $
Compensation Excluding Stock Options, Median - 84th Percentile	2,911,174	5,934,264	4,422,719
Zero to Average Option Awards	-	3,107,879	1,553,940
Total Annual Compensation	2,911,174	9,042,143	5,976,658

Footnote:

[a] Using guideline companies with $800 million in assets to $3.5 billion in assets. This range of asset size represents approximately 50 percent to 200 percent of the 9/30/2012 total asset size of Alpha.

Supplemental Financial Ratio Analysis: Benjamin Beta

ASSET BALANCE FROM $800,000,000 TO $3,500,000,000

NATIONAL CENTER FOR CHARITABLE STATISTICS - FORM 990 CORE FILES

ANNUAL COMPENSATION AS A PERCENT OF TOTAL ASSETS

Total Assets at Beginning of Year $	Compensation of Officers/ Directors $	Name of Organization	Compensation as a % of Total Assets
3,224,691,848	200,247	NORTHWESTERN MEMORIAL HOSPITAL	0.006%
3,023,233,140	9,433,421	TRINITY HEALTH-MICHIGAN	0.312%
2,958,848,111	8,230,168	SISTERS OF ST FRANCIS HEALTH SERVICES INC	0.278%
2,950,889,948	10,426,468	PARTNERS HEALTHCARE SYSTEM INC	0.353%
2,930,050,297	4,879,958	DUKE UNIVERSITY HEALTH SYSTEM INC	0.167%
2,775,777,168	4,297,831	TEXAS CHILDRENS HOSPITAL	0.155%
2,736,974,953	12,844,548	CATHOLIC HEALTHCARE PARTNERS	0.469%
2,727,541,033	11,420,955	ALLINA HEALTH SYSTEM	0.419%
2,694,067,000	12,251,000	UNIVERSITY HOSPITALS HEALTH SYSTEM INC	0.455%
2,578,396,030	12,950,331	CEDARS-SINAI MEDICAL CENTER	0.502%
		. . . . .	
800,504,683	4,337,604	RADY CHILDRENS HOSPITAL-SAN DIEGO	0.542%

Median Total Compensation as a % of Total Assets	0.465%
25th Percentile Total Compensation as a % of Total Assets	0.248%
75th Percentile Total Compensation as a % of Total Assets	0.668%
84th Percentile Total Compensation as a % of Total Assets	0.841%

Supplemental Financial Ratio Analysis: Benjamin Beta (cont.)

FUND BALANCE FROM $600,000,000 TO $2,500,000,000

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ANNUAL COMPENSATION AS A PERCENT OF FUND BALANCE

Fund Balance at End of Year $	Compensation of Officers/ Directors $	Name of Organization	Compensation as a % of Fund Balance %
2,038,637,976	4,297,831	TEXAS CHILDRENS HOSPITAL	0.211%
1,907,013,413	2,608,082	ST JUDE CHILDRENS RESEARCH HOSPITAL INC	0.137%
1,849,945,551	25,167,194	ADVOCATE HEALTH AND HOSPITALS CORPORATION	1.360%
1,831,220,400	9,433,421	TRINITY HEALTH-MICHIGAN	0.515%
1,757,202,000	11,307,000	MEMORIAL SLOAN-KETTERING CANCER CENTER	0.643%
1,727,020,143	8,230,168	SISTERS OF ST FRANCIS HEALTH SERVICES INC	0.477%
1,722,056,000	6,586,000	UNIVERSITY HOSPITALS HEALTH SYSTEM INC	0.382%
1,715,855,818	2,687,081	AMERICAN LEBANESE SYRIAN ASSOC CHAR INC	0.157%
1,687,332,402	17,827,571	SUTTER HEALTH	1.057%
1,674,141,100	18,239,413	BANNER HEALTH	1.089%
		. . . . .	
600,660,854	458,146	TOLEDO HOSPITAL	0.076%

Median Total Compensation as a % of Fund Balance	0.588%
25th Percentile Total Compensation as a % of Fund Balance	0.351%
75th Percentile Total Compensation as a % of Fund Balance	0.994%
84th Percentile Total Compensation as a % of Fund Balance	1.325%

Reasonable Compensation Conclusion – Benjamin Beta

	Indicated Range of Reasonable Compensation		
	Low	High	Average
Benjamin Beta Compensation Analysis	$	$	$
Salary Survey Analysis			
ERI Executive Compensation Assessor	955,888	2,307,516	1,631,702
Towers Watson Regression Analysis	1,119,185	2,212,936	1,666,061
Proxy Statement Analysis			
Total Compensation Excluding Stock Options	2,911,174	5,934,264	4,422,719
Zero to Average Value of Option Awards	-	3,107,879	1,553,940
Total Annual Compensation	2,911,174	9,042,143	5,976,658
Financial Ratio Analysis			
Total Officer Compensation as a Percent of Fund Balance/Total Assets	4,134,647	14,051,733	9,093,190
Conclusion (range of midpoints, excluding the financial ratio analysis)	Low	High	
Indicated Total Compensation for Alpha Chairman and CEO	$	$	
Benjamin Beta Range of Reasonable Compensation	1,631,702	5,976,658	

Supplemental Comparable Employee Analysis: Benjamin Beta

Ending	Name	Number of Employees	Fund Balance	Total Assets EOY	Name	Title	Compensation from Organization	Compensation from Related Organizations	Other Compensation	Total Compensation
8/31/2012	Howard Hughes Medical Institute	3,645	15,739,866,136	18,237,793,953	Robert Tijan, PhD	President	1,128,070	-	15,000	1,143,070
12/31/2011	Memorial Sloan-Kettering Cancer Center [a]	13,595	3,897,526,000	6,448,415,000	Harold Varmus, MD	President & CEO, Board Member MSK, MEM, SKI	1,234,315	-	102,732	2,005,571
12/31/2011	Memorial Sloan-Kettering Cancer Center [a]	13,595	3,897,526,000	6,448,415,000	Craig Thompson, MD	President & CEO, Board Member MSK, MEM, SKI	208,191	-	621	626,436
12/31/2011	The Cleveland Clinic Foundation	26,606	2,367,475,265	5,996,125,874	Delos M. Cosgrove	President & CEO	2,067,498	-	246,644	2,314,142
12/31/2011	Mayo Clinic	19,784	2,182,343,031	6,946,835,499	John M. Noseworthy	CEO & President	1,725,646		714,279	2,439,925
9/30/2012	Partners HealthCare Systems Inc.	6,065	(45,937,448)	3,349,320,793	James J Mongan, MD, MBA	President & CEO/Trustee	1,851,358	-	301,230	2,152,588
9/30/2012	Partners HealthCare Systems Inc.	6,065	(45,937,448)	3,349,320,793	Gary Gottlieb, MD, MBA	President & CEO/Trustee	1,576,310	-	64,972	1,641,282
9/30/2012	Children's Hospital Corporation (Boston)	10,266	1,852,729,107	3,065,308,985	James Mandell, MD	CEO/Noncomp Trustee	1,453,631	-	424,165	1,877,796
6/30/2012	Cedars-Sinai Medical Center	11,820	1,683,323,760	3,349,460,552	Thomas M. Priselac	President/CEO	2,553,663	-	1,364,544	3,918,207
6/30/2012	St. Jude Children's Research Hospital Inc.	4,025	2,123,269,905	2,440,966,547	William E. Evans	Director and CEO	660,479	-	135,059	795,538
6/30/2012	Johns Hopkins Hospital	10,726	931,269,889	2,375,941,191	Ronald R. Peterson	President	1,774,090	-	144,011	1,918,101
6/30/2012	Baylor Health Care System	2,343	12,671,576	1,996,544,365	Joel Allison	President/CEO/Trustee	1,921,744	-	353,051	2,274,795
9/30/2012	The Scripps Research Institute	2,861	683,055,077	850,789,296	Richard A. Lerner, MD	President, CEO	1,039,101	-	331,227	1,370,328
9/30/2012	Beckman Research Institute of the City of Hop	972	636,940,312	739,833,649	Michael A Friedman, MD	President and CEO	-	929,821	212,706	1,142,527
6/30/2012	Fred Hutchinson Cancer Research Center	3,074	193,005,264	555,798,313	Leland H. Hartwell	President & Director	722,011	-	-	722,011
									High	3,918,207
									Average	1,756,154
									Median	1,877,796
									Low	626,436

Footnotes:
[a] Harold Varmus, MD served as CEO for approximately 8 months and Craig Thompson, MD served as CEO for approximately 4 months. We annualized total compensation for both executives.

Summary and Conclusion: Benjamin Beta

- The total compensation paid to Mr. Beta is $1.792 million.
- Based on the results of the salary survey analysis, the reasonable annual compensation for Mr. Beta is in the range of $956,000 to $2,308,000 (rounded).
- Based on the results of the proxy statement analysis, the reasonable annual compensation for Mr. Beta is in the range of $2,911,000 to $9,042,000 (rounded).
- Synthesizing the results of the salary survey analysis and proxy statement analysis—the midpoint range of reasonable annual compensation for Mr. Beta is: $1,632,000 to $5,977,000 (rounded).

Summary and Conclusion: Benjamin Beta (cont.)

- Although we did not weight the financial ratio analysis, this analysis indicated the annual compensation available for Mr. Beta is in the range of: $4,135,000 to $14,052,000 (rounded).
- Based on our analysis, Mr. Beta's compensation is on the lower end of the concluded range.

Illustrative Compensation Committee Presentation Summary and Conclusion

- In our analysis, we considered each of the *Internal Revenue Manual* (*Mayson*) factors for each executive.
- We specifically relied on the results of a salary survey analysis and a proxy statement analysis.
- We confirmed those results with a financial ratio analysis.
- We also specifically identified and considered comparable executives at comparable institutions.
- Each executive's compensation falls within a reasonable range of compensation.

Independent Investor Test Illustrative Example Fact Set

- Omega & Associates ("Omega"), a C corporation, is an independent insurance agency for AFLAC.
- Sam Psi ("Psi") is the sole shareholder, sole officer, and sole professional employee.
- The IRS challenged the Omega corporate tax return deduction for Psi's compensation for 2009, 2010, and 2011.
- Psi's compensation was:

2009	$875,000
2010	$800,000
2011	$800,000

- The analyst decided to use the independent investor test to measure the reasonableness of Psi's compensation.

Omega Income Statements

(in $)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total receipts	314,724	443,102	425,811	597,574	793,651	1,202,040	1,646,998	1,812,048	1,673,379	1,554,512
Total expenses	266,962	421,006	479,626	596,905	727,843	1,197,719	1,576,514	1,584,199	1,654,179	1,594,142
Special deductions	209	237	43	669	--	--	--	5,254	4,663	--
Taxable income	47,553	21,859	-53,858	--	65,808	4,321	70,484	222,595	14,537	-39,630
Income tax	7,133	3,279	--	--	11,452	648	12,621	70,062	2,181	--
Net income	40,420	18,580	-53,858	--	54,356	3,673	57,863	152,533	12,356	-39,630
Profit before interest & taxes	47,553	21,859	-53,858	590	65,808	5,308	80,119	244,595	34,592	-36,390
Pre-tax profit margin	16.55%	5.34%	-12.54%	0.00%	8.31%	0.36%	4.28%	12.34%	0.88%	-2.55%
After tax profit margin	14.06%	4.54%	-23.65%	0.00%	6.86%	0.31%	3.51%	8.45%	0.75%	-0.26%
Psi compensation	51,390	234,241	76,794	205,323	350,000	416,253	781,442	875,000	800,000	800,000

Omega Balance Sheets

(in $)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total assets	70,140	84,068	58,852	48,899	89,219	77,090	502,903	820,200	1,207,024	1,675,564
Total liabilities and stockholders' equity	70,140	84,068	58,852	48,899	89,219	77,090	502,903	820,200	1,207024	1,675,564
Total shareholders' equity	60,862	74,703	2,859	(16,457)	29,918	17,822	65,226	88,862	51,479	123,611

Omega Actual Officer's Compensation

Year	Compensation $	Total Revenue $	Net Income $
2011	800,000	1,554,512	(39,630)
2010	800,000	1,673,379	12,356
2009	875,000	1,812,048	152,533
2008	781,442	1,646,998	57,963
2007	416,253	1,202,040	3,673
2006	350,000	793,651	54,356
2005	205,323	597,574	0
2004	76,794	425,811	(53,858)
2003	234,241	443,102	18,580
2002	51,390	314,724	40,420

Omega Fair Return on Shareholder Equity Analysis Required Return on Equity [a]

Required Return on Equity	2009	2010	2011
Risk-free rate [a]	1.96%	2.04%	2.64%
General equity risk premium [b]	7.20%	7.20%	7.10%
Small stock equity risk premium [b]	4.01%	4.02%	3.95%
Company-specific equity risk premium	3.00%	3.00%	3.00%
After tax required return on equity	16.17%	16.26%	15.69%
Total income tax rate [c]	34%	34%	34%
Pre-tax return on equity (rounded)	24.5%	24.6%	23.8%

Notes:

[a] Based on CAPM, build-up model, Duff & Phelps model, public company DCF model, or any other cost of equity capital model

[b] Industry-adjusted

[c] Combined federal and state income tax rate

Omega Fair Return on Shareholder Equity Analysis

	2009	2010	2011
Taxable income	222,595	14,537	(39,630)
Add Psi compensation	875,000	800,000	800,000
Income before taxes and Psi compensation	1,097,595	814,537	760,370
Fair return on shareholders' equity			
Beginning shareholders' equity book value	65,226	188,862	151,479
Times required return on equity	24.5%	24.6%	23.8%
Fair return to shareholders	15,980	46,460	36,052
Available for officer's compensation	1,081,615	768,077	724,318
Actual compensation	875,000	800,000	800,000
Under/(over)-compensation	206,615	(31,923)	(75,682)
Cumulative under/(over)-compensation	206,615	174,692	99,010

Independent Investor Test Illustrative Example Conclusion

- During the subject three year period, Omega paid $2,475,000 in compensation to Psi
- During the subject three year period, based on our application of the independent investor test, a reasonable level of compensation for Omega to pay to Psi was $2,574,010
- Even though Psi earned greater than a reasonable level of compensation in 2010 and 2011, his cumulative compensation was reasonable for the subject three year period

Reasonable Compensation Analysis Caveats

- The “multiple hats” method is not preferred by the courts
- Courts prefer that the subject employee work full time and not be an absentee owner
- Describe all of the subject employee’s activities
- Reconcile the results of the multiple factor analysis and the independent investor analysis
- Explain why you used each method within each type of analysis
- Explain why you used each data source within each type of analysis
- Narratively explain why the subject employee is responsible for any company excess earnings
- Describe all of your due diligence procedures
- The report narrative should be clear, convincing, and cogent
- The analysis should be replicable, verifiable, and transparent

Summary and Conclusion

- Reasons to conduct the reasonable compensation analysis
- Alternative standards to determine reasonableness of compensation
- Two categories of analyses
  - Multiple factor test analyses
  - Independent investor test analyses
- Considerations in the reasonableness of compensation analysis
- Multiple factor test illustrative example
- Independent investor test illustrative example
- Reasonableness of compensation analysis caveats