

DETERMINING REASONABLE COMPENSATION

The Income Approach



The Income approach (AKA Independent Investors Test) seeks to determine whether a hypothetical investor would be satisfied with their return on investment when looking at the financial performance of the business in conjunction with the compensation level of the owner.



The income approach can only be correctly applied when the Fair Market Value (FMV) of the company is available for each year that compensation is examined.



In order to determine the Reasonable Compensation using the Income approach you need three pieces of information:

- #1 Fair Market Value (FMV) of the business at the beginning of the year.
- #2 Increase in FMV by the end of the year before owner compensation
- #3 Target return of the Independent Investor

Plug these three values into an Income approach calculator to determine Reasonable Compensation using the Independent Investors test.

Income approach is the only method that does not rely on comparability data, but instead draws a conclusion for what Reasonable Compensation should be based on the financial performance of the business. This approach generally works best when there is no comparability data available.

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