Co-ownership: a taxing relationship

by William P. Prescott, EMBA, JD

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Practices consisting of two or more owners are becoming more common as the number of practices that expand or relocate increases. As a result, if you are planning to admit Dr. Junior to your practice or are in co-ownership, you need to be aware of significant tax risks that your other partner, the IRS, thinks are important under the three business and tax structures for co-ownership.

Each business and tax structure consists of three categories: the associate buy-in, the owner buy-out, and operations.[1] All categories need to be considered when contemplating co-ownership because dealing with these complex issues a year or two after the associateship begins is likely to lead to disagreements over the purchase price, valuation date, and business and tax structure.

Purchase and sale of stock in after-tax dollars

The first business and tax structure is the purchase and sale of stock in a professional corporation in after-tax dollars. It is the only one without any tax risk. Unfortunately, it is also the one used the least.

Under this structure, Dr. Junior pays income tax on all compensation earned and then pays for the stock in after-tax or nondeductible dollars, while you pay tax as capital gains on the proceeds from the sale of the stock. Therefore, all taxes are accounted for, and you, Dr. Junior, and the practice are free from IRS scrutiny in the event of an audit.

This business and tax structure only works from an economic standpoint where the tax-neutral fair market value of the practice is adjusted downward to account for Dr. Junior paying for stock, without any ability to deduct the purchase price in light of your receiving capital gains treatment. The downward adjustment applies to both the buy-in and buy-out.

Stock excluding goodwill

➤ **Risk 1 — compensation shifts** — The purchase and sale of stock for the buy-in to a professional corporation at a low value, often the fair market value of the professional corporation's tangible assets, is sometimes coupled with a compensation shift to you, which represents your goodwill. In exchange for selling a fractional interest of your goodwill, you receive additional compensation, often increased for the tax effect of receiving ordinary income instead of capital gains and again for an interest component, by providing administrative and management services to the practice under a practice-management agreement.

Although compensation shifts have not yet presented tax problems in the buy-in piece of the transaction,[2] assuming that the compensation shifted equates to the management services provided,[3] problems do arise in the buy-out.

➤ **Risk 2 — deferred compensation** — Sometimes buy-outs are structured with stock being purchased by the professional corporation at a low value, coupled with the payment over time by the practice to you, of deferred or continued compensation,[4] which represents your remaining goodwill. While payments for deferred compensation are deductible to the practice, they are taxable as ordinary income to you.

Moreover, deferred compensation arrangements are now subject to the complexities of Internal Revenue Code (IRC) Section 409A and its harsh penalties for noncompliance. The primary effects to you are strict rules on the payment of accounts receivable, no ability to prepay the deferred compensation, and the requirement of a complete separation from service, which means that with limited exceptions you cannot continue to work for the practice on a part-time basis upon retirement.

➤ **Risk 3 — personal goodwill** — Another buy-out structure, which is supported by case law,[5] is where your stock is purchased by the practice at a low value but is coupled with the purchase of your personal goodwill. To the extent that there is personal goodwill,[6] the purchaser, which is the practice, is able to amortize or deduct the personal goodwill over 15 years while the purchase of stock cannot be deducted. To you, the personal goodwill should, arguably, be taxed as capital gains at one level and not double taxed.

Understand, however, that the purchase and sale of personal goodwill is not without problems. First, if personal goodwill is part of the transaction, you cannot have been, or have a written agreement that you will be, subject to a restrictive covenant with the practice upon the buy-out.[7] This point effectively eliminates this business and tax structure because Dr. Junior will require that you be subject to a restrictive covenant and vice versa. Second, if the practice was formed prior to Aug. 10, 1993, the goodwill is not deductible.[8] If this approach is used, it is important to have an appraisal that distinguishes your personal goodwill vs. any corporate goodwill.

Three-entity method

Finally, an increasingly common business and tax structure for co-ownership is for Dr. Junior to form an S-corporation and purchase a fractional interest in the tangible assets and goodwill from you or your practice entity. After the purchase, you and Dr. Junior operate the practice through a newly formed limited liability company or partnership, a third entity that collects the revenue, pays the operating expenses including employee benefits, and employs the staff. Profits are distributed to the entities, which are owned by you and Dr. Junior and which pay the direct business expenses of each owner. The three-entity method may also include use of a compensation shift, the purchase of personal goodwill, inappropriate S-corporation distributions, or misclassified inde-

pendent contractor relationships.

➤ **Risk 4 — the anti-churning rules** — If your practice was formed prior to Aug. 10, 1993, the buy-in and buy-out under the three-entity method, as well as the purchase of personal goodwill by the practice upon your buy-out, is subject to the IRC Section 197 anti-churning rules. The anti-churning rules deny amortization of the goodwill purchased by Dr. Junior[9] if you and Dr. Junior jointly did or will own 20% or more of the third entity[10] or are family members; e.g., you and your son or daughter/dentist. It is the third entity, the limited liability company or partnership, that creates the problem for nonrelated owners because 20% or more common ownership makes you related parties. IRC Section 197 does not provide for separation of the pre- and post-Aug. 10, 1993, goodwill.[11] While I have not seen any audits on this point yet, note that the IRS is well aware of this situation and can track asset sales through forms that must be filed by both you and Dr. Junior, and there is direct authority under the IRC Section 197 Regulations for the IRS to recast the transaction should it choose to do so.

If, on the other hand, you and Dr. Junior operate separate practices under a solo group arrangement with no common ownership of a third entity, the goodwill is amortizable for the buy-in and buy-out, except for family members. What's more, each separate practice may adopt its own tax-qualified retirement and health plans without covering the eligible employees of both practices. Shared employees — e.g., hygienists — are permitted under solo group arrangements.

Notwithstanding the ability to amortize pre-Aug. 10, 1993 goodwill, solo groups work well because Dr. Junior is usually not required to purchase your practice upon retirement but retains the option to do so. Because the practices are separate, you can sell your practice to a third-party dentist if Dr. Junior does not exercise the option to purchase. Death or permanent disability, however, usually requires a mandatory purchase.

Summary and thoughts

Remaining a solo practitioner is best, and practicing in a solo group is second best. If you are contemplating admitting Dr. Junior as a co-owner or are in co-ownership, any of the three business and tax structures can work if the tax risks are recognized and not taken. Hire advisors with experience in these transactions and expect tax risks to be disclosed.

- **Stock in after-tax dollars** — If the practice was formed prior to Aug. 10, 1993, my recommendation for co-ownership is the purchase and sale of stock and after-tax dollars, with adjustments for the tax benefit in light of the tax detriment. It is simple. There are no tax risks, and there is one entity.
- **Stock excluding goodwill** — While a headache to calculate and keep track of, compensation shifts are workable for the buy-in piece. For the buy-out, stock at a low value coupled with deferred compensation works well provided you understand that the payments will be over time and a complete separation from service with the practice is necessary. Stock at a low value coupled with the professional corporation's purchase of your personal goodwill is viable provided that you do not, or have not agreed in writing, to have a restrictive covenant with the practice, and provided that the practice was formed after Aug. 10, 1993.
- **Three-entity method** — The three-entity method does work well if the practice was formed after Aug. 10, 1993, and the owners are unrelated, notwithstanding the complexity and increased accounting costs of operating three entities. If the practice was formed prior to Aug. 10, 1993, understand that the goodwill sold is not amortizable or deductible to Dr. Junior. However, stay away from S-corporation dividends and do not attempt to classify the member/partner corporations as independent contractors. Finally, solo group arrangements provide a good alternative in most circumstances to allow for goodwill to be amortized where it otherwise would not be.

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Letters from Readers

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With all of the discussion going on, I do feel there is one important element — it may be the most important element — in proper treatment planning, and that is the patient. I refer to this in my column as well. You can claim to have all the evidence-based periodontal and dental treatment planning available, but you must involve the patient who is sitting in front of you in the treatment planning process. If we are going to retain teeth, will they (patients) keep up with proper oral hygiene, recall visits, improve their nutrition, reduce their health risks, and a myriad of other factors to maintain their periodontal and overall health? Or, will they be able to take better care of dental implants because they have given up on their natural dentition? Many clinicians don't like to hear that, but anyone who really understands patients knows how important this factor really is.

I think that Drs. Low and Clem may have missed this very important point — to me as a wet-gloved practicing general dentist — it is equally important to assess the personality of patients in terms of how they take care of their dental and overall health, as well as their desire as to what they want to accomplish with their overall treatment plan. Perhaps that is even more important than evaluating the scientific evidence, patients' periodontal condition, the type of bone they have, and their overall bone support. That has somehow been left out of the conversation, and to me this is one of the most salient points when determining treatment plans for the patients of my own practice.

I once again thank Drs. Low and Clem for joining this discussion, and I certainly hope it continues as it brings important periodontal issues once again to the forefront. DE

SHORT™ Implants with Dr. Vincent Morgan

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DE: Have you seen increased patient acceptance for implant treatments with the use of these implants?

Dr. Morgan: Yes, and whenever other dentists can confidently offer a patient a straightforward cost-effective procedure in a timely manner without the inherent risks and expense of surgical bone grafting procedures, they too will experience an increased acceptance of their implant treatments.

DE: How many years have these implants been in use?

Dr. Morgan: Bicon implants have been used continuously since 1985. Any implant or component including the instrumentation that was manufactured in 1985 is compatible with implants, components, and instrumentation being manufactured today. DE

References available upon request.

Dr. Vincent J. Morgan maintains a private practice in Boston. After placing his first implants in 1970, and years of implant experience with many different systems, he was part of a group that purchased the dental division from Stryker Instruments to form Bicon in 1994. Currently, he serves as president of Bicon, LLC, and is responsible for the development of the Integrated Abutment Crown (IAC). Contact Dr. Morgan at vmorgan@bicon.com

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Ask your advisors to keep your other partner (the IRS) in mind when developing the business and tax structure of your co-ownership for the buy-in/buy-out with Dr. Junior. DE

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References

1. This article does not consider operations, which consists of allocation of compensation in all forms and benefits, decision making control, and employment of family members.
2. Tax Planning for Corporations and Shareholders, Second Edition, Zolman Cavitch, Lexis Publishing, Matthew Bender & Company, Inc. 13.04[1], [2], [3].
3. Pediatric Surgical Associates, P.C. v. Commissioner, T.C. Memo 2011-81, April 2, 2001.
4. Revenue Ruling 60-31.
5. The following Technical Advice Memorandum and Revenue Ruling recognize the partial transfer of personal goodwill: TAM 200244009; Revenue Rule 70-45.
6. The following recent cases recognize the existence of personal goodwill: Muskat v. U.S.; 554 F.3d 183; Solomon v. Commissioner, T.C. Memo. 2008-102, 208 WL 1744406 (U.S. Tax Ct.).
7. Martin Ice Cream v. Commissioner, 110 T.C. No. 189 (1998); Norwalk v. Commissioner, T.C.N. 1998-279.
8. The Tax Advisor, Sept. 2009, 9-09 T.T.A. 573, Thomas I. Broder, Elkart, IN.
9. IRC Section 197 (f)(9)(A)(i); IRC Reg. 1.197-2(h)(2)(i).
10. IRC Reg. 1.197-2(h)(6)(i)(A).
11. Mergers, Acquisitions, and Buyouts. Martin D. Ginsburg, Jack S. Levin, Dec. 2002, Aspen Publications, 4-118, Example 17, Section 403.4.4.4.

Dental desperation

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This situation was a reality check for me. I learned that everyone is not totally honest. I also should have had better safeguards in place with the scrap gold storage. We did have a system in place to make sure what was supposed to be in each lab case was, in fact, there when it arrived at the office, although now it is very well documented and monitored.

I would suggest that as practice owners you understand the lengths desperate people will go to in order to feed their habit or possibly even survive.

I leave you with the following three suggestions:

- Make sure any gold or other easily saleable items are kept in a secure place, inventoried, and monitored.
- Make sure there is a foolproof check-in system for all lab work as it arrives.
- Never assume these things always happen only to someone else. DE

Dr. Bradley Dykstra is a general dentist in private practice in Hudsonville, Mich. A graduate of the University of Michigan's dental school, he earned his MBA from Grand Valley State University. He speaks on integrating technology into dentistry, and consults via his company, Anchor Dental Consulting. Reach him at drdykstra@anchordentalconsulting.com or (616) 669-6600.