PRESCOTT'S PERSPECTIVE ON TRANSITIONS

William P. Prescott, JD, EMBA

Determining the purchase price of your practice; should you also sell the building?

QUESTION: I'm in the process of selling my practice, which operates as a C-corporation. How is the purchase price allocation determined?

WP: The purchase price allocation is determined by a calculation of the fair market value of all tangible assets and goodwill. The practice valuation should include an asset summation formula that will determine the fair market value of all tangible assets, and the selling price above the tangible assets will be goodwill, personal, or corporate. Note that there may be multiple valuations used for the practice valuation, and the tangible asset value will be extracted from the asset summation formula. However, the practice valuation will not, with rare exceptions, distinguish personal from corporate goodwill, which requires a thorough analysis of personal versus corporate goodwill through a specific goodwill appraisal.[1]

Tangible assets include dental equipment, office equipment, furniture, and technology. Dental supplies and instruments are also tangible assets. Goodwill, personal or corporate, is patients returning and sources referring to the practice time and time again, and represents the selling and purchase price above the fair market value of tangible assets. If you and/or the purchaser disagree on the allocation of tangible assets as a percentage of the goodwill, engage the dental equipment and supply company that you work with to value the tangible assets at their

Editor's note: In this bimonthly column, William Prescott, JD, EMBA, will address select questions around the topic of practice transitions, including partnerships. Submit a question by emailing wprescott@wickenslaw.com—names will not be published.

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fair market value. The fair market value of tangible assets is their in-place and operational value, as opposed to depreciated or replacement value. There will also be an allocation to dental supplies and instruments. For dental supplies, consider three to four months on hand and for dental instruments, one-half of one percent of one year's collections.

By practicing through a C-corporation, the sale of goodwill is double taxed, which is, by far, the largest part of the sale and purchase price. Since 1998, advisors have attempted to minimize or eliminate the double tax based on two favorable tax court cases.[2] With personal goodwill, some advisors have taken the position that you should not file a Form 8594 as an individual because the sale of personal goodwill without any other asset does not constitute a "trade or business."[3] However, the tax regulations provide that the sale of any group of assets constitutes a trade or business in the hands of either the seller or purchaser. Therefore, because the purchaser buys tangible assets from your corporation and personal goodwill from you, there is a trade or business requiring that Form 8594 be filed by your corporation and you. If you don't file a Form 8594 individually, the allocations won't match under the purchaser's Form 8594, which could trigger an audit, and there are penalties for not filing under the tax code.[4]

The Internal Revenue Service (IRS) requires sellers and purchasers to report the allocation of the sale and purchase price on Form 8594 in accordance with defined categories.[5] Depending on the fair market value of each category, there will be an allocation to the seller of capital gains for goodwill and usually ordinary income for tangible assets. Although the allocation of the selling and purchase price will be binding on both the seller and purchaser under a written agreement, the IRS retains the ability to challenge the allocation. The allocation of the selling and purchase price becomes more significant at any time when the difference between ordinary income and capital gains widens.

QUESTION: When I sell my dental practice, should I also sell the building that I own?

WP: When you sell your dental practice, you have no reason to continue to own the building. Should the purchasing dentist relocate, you may have an unusable facility, depending on the building. While it's always nice to have rent income continue to your real estate entity or you, you would receive fair market value for the building when you sell it. You are fully paid, and the purchaser is happy because he or she can pay rent to himself or herself.

However, the purchaser may be required to obtain a down payment, e.g., 20%, that may be difficult to obtain when the purchaser buys your practice. Therefore, you may lease the real estate to the purchaser with an option for the purchaser to buy the building through a newly formed limited liability company, along with a right of first refusal if you find another purchaser to buy it. If an offer is made to buy the building, the purchaser's entity or purchaser would have the ability to match the third-party offer.

The real estate value under an option to purchase is based on an appraisal either agreed upon by the parties, or each party obtaining an appraisal from a commercial real estate appraiser. If each party gets an appraisal, the appraisals are averaged. If the appraisals are more than a certain percentage apart, e.g., 10%, the appraisers select a third commercial real estate appraiser whose appraisal will be final and binding.

There may be a "must buy" provision contained in the option and right of first refusal agreement, which would state that the purchaser's real estate entity must purchase the building on or before a specified date—for example, five years after the sale and purchase of the dental practice.

The new practice owner should want to purchase the real estate, assuming that he or she plans to remain in the current location. If the purchasing dentist plans to relocate the practice, he or she should not purchase it due to the build-out costs associated with relocating. **DE**

REFERENCES

1. Kennedy v. Commissioner, T.C. Memo 2010-206.
2. Martin Ice Cream Co. v. Commissioner. 110 T.C. No. 189 (1998); Norwalk v. Commissioner, T.C. Memo 1998-279, 76 TCM 208 (1998).
3. Internal Revenue Code Section 1.1060-1. Special allocation rules for certain asset acquisitions. https://www.law.cornell.edu/cfr/text/26/1.1060-1
4. Internal Revenue Code Section 6721(e)(2). Failure to file correct information returns. https://www.law.cornell.edu/uscode/text/26/6721
5. Internal Revenue Code Reg. 1060-1T(h). Special allocation rules for certain asset acquisitions. https://www.law.cornell.edu/cfr/text/26/1.1060-1

William Prescott, JD, EMBA, of Wickens Herzer Panza in Avon, Ohio, is a practice transition and tax attorney and former dental equipment and supply manager and representative. His most recent book, Joining and *Leaving the Dental Practice*, is available through the ADA Center for Professional Success. ADA members can download the e-book for free at success.ada.org/en/practice-management/joining-and-leaving-the-dental-practice. For this and Prescott's other publications, visit prescottdentallaw.com. Contact him at (440) 695-8067 or wprescott@wickenslaw.com.