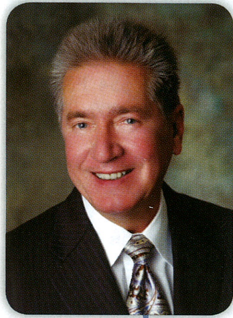
Co-Ownership — It's Taxing!



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2012 Conference Speaker

Dental and dental specialty practices consisting of two or more owners continue to grow. If you are planning to admit Dr. Junior as an owner, you and Dr. Junior need to be aware of the tax risks that your other partner, the IRS, thinks are important under three business and tax structure choices.

Each business and tax structure consists of three categories. They are the associate buy in, the owner buy out, and operations. All categories need to be considered when co-ownership is contemplated because dealing with these complex issues a year or two after the associateship begins will cause disagreements over payment terms, 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 non-deductible 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 you receiving capital gains treatment. The downward adjustment applies to both the buy in and buy out. However, when Dr. Junior sells his or her stock in the future, Dr. Junior only pays capital gains above the purchase price paid.

STOCK EXCLUDING GOODWILL

Compensation Shifts

The purchase and sale of stock for the buy in to a professional corporation excluding goodwill, 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.

Compensation shifts have not yet presented tax problems in the buy in piece of the transaction, assuming that the compensation shifted equates to the management services provided. This could change if the IRS makes an argument that the compensation shifted is a non-deductible dividend where the practice operates as a C corporation.

Personal Goodwill for the Buy in

Rather than utilize a combination of stock excluding goodwill and a compensation shift, some advisors are advocating that Dr. Junior individually purchase an undivided interest in your goodwill for the buy in. This method won't work because personal goodwill is not deductible to an individual who is not a "trade or business".

Deferred Compensation

Sometimes buy outs are structured with stock being purchased by the professional corporation excluding goodwill, coupled with the payment, over time by the practice to you, of deferred or continued compensation, 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 IRC Section 409A and its harsh penalties for non-compliance. The primary effects to the practice are strict rules on the payment of accounts receivable and no ability to prepay the deferred compensation. To you, the buy out is not payable in cash, but over time. However, if there are more than two owners, your buy out will probably not be payable in cash, unless all remaining owners participate.

Personal Goodwill for the Buy out

Another buy out structure, which is supported by case law, is where your stock is purchased by the practice excluding goodwill, but is coupled with the purchase by the practice of your personal goodwill. To the extent that there is personal goodwill, the purchaser, which is the practice and not Dr. Junior, 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 at 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 be, or have a written agreement that you will be, subject to a restrictive covenant with the practice upon your buy out. This point effectively eliminates this business and tax structure because Dr. Junior will require you to be subject to a restrictive covenant and vice-versa. Second, if the practice was formed prior to August 10, 1993, the goodwill is not deductible. If this approach is used, it is important to have an appraisal that distinguishes your personal goodwill versus any corporate goodwill.

THREE ENTITY METHOD

Finally, this 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 by the limited liability company or partnership to the corporations, 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, questionable S corporation

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distributions (as every dollar distributed in a limited liability company or partnership is earned income) and/or independent contractor relationships.

The Anti-Churning Rules

If your practice was formed prior to August 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 if you and Dr. Junior jointly own twenty percent or more of the third entity or are family members, e.g., you and Dr. Junior are son or daughter dentist. It is the third entity, the limited liability company or partnership, that creates the problem for non-related owners because 20% or more common ownership makes you and Dr. Junior related parties. IRC Section 197 does not provide for separation of the pre and post-August 10, 1993 goodwill. The IRS is well aware of this situation and can track asset sales through Forms 8594 that must be filed by both you, your practice entity and Dr. Junior. While there is authority under Example 19 in the IRC Section 197 Regulations to avoid application of the anti-churning rules, there is also authority for the IRS to recast the transaction, should it choose to do so. This makes me a little uncomfortable with Example 19.

If, on the other hand, you and Dr. Junior operate separate general 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-August 10, 1993 goodwill, solo groups work well because Dr. Junior is usually not required to purchase your practice upon your retirement, but retains the option to do so. Because the practices are separate, you can sell your practice to a third party if Dr. Junior does not exercise the option to purchase. Death or permanent disability, however, usually requires a mandatory purchase. Solo group arrangements do not work well for specialty practices, although there are limited exceptions.

SUMMARY AND THOUGHTS

If you are contemplating admitting Dr. Junior as a co-owner or are now in co-ownership, understand and avoid the tax risks. If you are in co ownership, revise your ownership agreements to comply with the tax laws.

Stock in After-Tax Dollars

Especially if the practice was formed prior to August 10, 1993, my recommendation for co-ownership is the purchase and sale of stock and after-tax dollars, with a downward adjustment, because the stock is not deductible and you receive capital gains treatment. 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. The purchase of an undivided half interest in your personal goodwill by Dr. Junior individually will not work. For the buy out, stock excluding goodwill, coupled with deferred compensation works well provided that you understand that the payments will be over time. Stock excluding goodwill, 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 August 10, 1993.

Three Entity Method

The three entity method does work well if the practice was formed after August 10, 1993 and you and Dr. Junior are unrelated, notwithstanding the complexity and increased accounting costs of operating three entities. If the practice was formed prior to August 10, 1993, the goodwill sold is not amortizable or deductible to Dr. Junior. Solo group arrangements provide a good alternative, in most circumstances, to allow for goodwill to be amortized where it would otherwise not be.

Expect your advisors to keep your and Dr. Junior's other partner, the IRS, in mind when developing the business and tax structure of your co-ownership for both the buy in and buy out with Dr. Junior.

[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]Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Comm., 109 AFTR 2d 2012-XXXX, 05/17/2012.

[5]Internal Revenue Code ("IRC") Reg. 1.212-1.

[6]Revenue Ruling 60-31.

[7]The following Technical Advice Memorandum and Revenue Ruling recognize the partial transfer of personal goodwill: TAM 200244009; Revenue Rule 70-45.

[8]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.).

[9]*Martin Ice Cream v. Commissioner*, 110 T.C. No. 189 (1998); Norwalk v. Commissioner, T.C.N. 1998-279; Howard v. U.S., 2010 WL 3061626 (E.D. Wash. July 30, 2010); United States Court of Appeals for the 9th Circuit, No. 10 35768, D.C. 2:08-cv-00365-RMP.

[10]The Tax Advisor, September 2009, 9-09 T.T.A. 573, Thomas I. Broder, Elkart, IN.

[11]IRC Section (f)(9)(A)(i); IRC Reg. 1.197-2(h)(2)(i).

[12]IRC Reg. 1.197-2(h)(6)(i)(A).

[13]Mergers, Acquisitions, and Buyouts, Martin D. Ginsburg, Jack S. Levin, December, 2002, Aspen Publications, 4 118, Example 17, Section 403.4.4.4.

[14]IRC Reg. 1.197-2(k), Example 19.

[15]IRC Section 197(f)(9)(F); IRC Reg. 1.197-2(h)(11).

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