Exit Planning for Professionals

By Daniel H. McCarthy, William P. Prescott, and Steven B. Gorin

Estate and succession planning for a professional can present a set of challenges to advisors different from the norm. Because professionals are required to be licensed, and state professional regulatory authorities limit ownership to licensed professionals, a professional does not have the ability to pass ownership to future generations unless the professional's children happen to follow in his footsteps. In most cases, the professional will need to plan an exit strategy that involves the transfer of his ownership interest to other partners or to an associate.

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In many instances, professionals forming a new entity together in which to practice may not want to think about exit scenarios. But a new entity's formation is often the best time to address these issues. A well-drafted agreement among the owners will set forth both the methodology for computing a buyout price as well as the various triggering events that would cause a buyout, such as retirement, death, disability, a desire to practice with another group, the loss or suspension of professional license, or for other reasons. The buyout price can differ among the various scenarios, and the price can be expressed as a percentage of the buyout valuation. The agreement also should set forth how and when payments will be made to the professional exiting the practice. As discussed below, choice of entity does affect the form a buyout can take, as well as the income tax consequences for both the remaining professionals and the retiring professional.

Understanding the valuation of a professional practice is an important step in structuring a buyout.

Valuation of Professional Practices

Although attorneys are not usually involved in the valuation of a professional practice involving a complete or fractional sale and purchase, they need to understand the process to ensure that the economic terms are fair to all concerned. The three common methods of valuing professional practices are asset

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summation, capitalization of earnings, and comparison of similar practices. The methodology is the same for a complete or fractional sale and purchase. Accounts receivable are excluded from the valuation and can be included or excluded from the transaction.

Asset Summation

The asset summation method calculates the fair market value of (1) tangible assets consisting of professional equipment, office equipment, furniture, and technology, (2) supplies, (3) medical or dental instruments (if applicable), and (4) goodwill, be it personal to the practice owner or attributable to the practice entity.

The fair market value of tangible assets usually can be calculated by the equipment company that sold the equipment to the practice. Another method for the valuation is by taking the equipment's book value and adding to it one-third of the depreciation previously taken without regard to accumulated depreciation. Finally, a 10-year straight-line depreciation value can be used, with a 20% salvage value for certain assets.

The fair market value of supplies can be calculated by determining the supply level normally on hand and adding the cost of supplies for the last calendar or fiscal year, dividing by 12, and multiplying by the number of months of supplies on hand.

Instruments are typically a small percentage of one year's collections. In dental or dental specialty practices, it is usually 0.5% of one year's collections.

The Goodwill Registry, compiled yearly by The Healthcare Group, Inc., provides a 10-year running average for almost all professional practices. Medical practices are on the low side, with goodwill calculated at roughly 20% of one year's collections. Dental and dental specialty practices are the highest, with goodwill of 46.85% as the statistical mean in a general dental practice. The Goodwill Registry lists the number of practices reviewed and provides categories of no goodwill, statistical mean, statistical median, and high and low. In addition, some medical professions have publications on goodwill and practice values. For example, the most recent version of the American Dental Association's publication, *Valuing a Practice, A Guide for Dentists* (Practice Management Series/American Dental Association 2006), states that goodwill based on annual collections should range between 20% and 50%. When goodwill is based on annual owner/doctor compensation in all forms, the multiple ranges between 1.0 and 1.5.

Capitalization of Earnings

The term "capitalization rate" is the percentage by which a constant income stream is divided to obtain the value of a business on the basis of an assumed rate of return. In other words, the income stream is the yearly cash flow available to pay the purchase price. Assuming this sum is an even amount each year, the reciprocal of the payback period could be regarded as the capitalization rate. A 20% capitalization rate equates to a five-year repayment period, whereas a 14.28% rate equates to a seven-year repayment period. The lower the capitalization rate, the longer the repayment period. A 20% capitalization rate is often used in the valuation of professional practices, particularly for dental and dental specialty practices. Capitalization rates are based on the nature of the business, the risk involved, and the stability or regularity of earnings.

Similar Practices

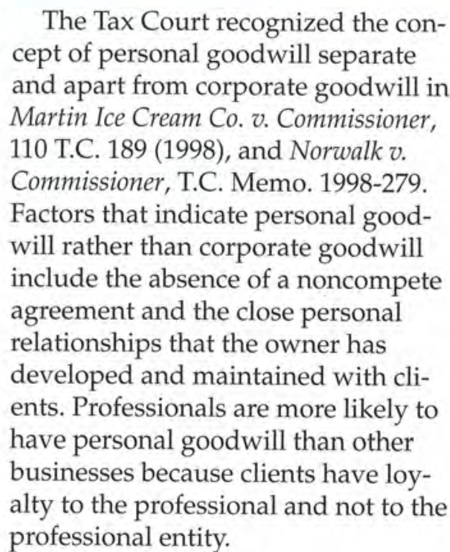
This overused valuation method is flawed because it relies on a false generalization. Few practices in the same profession have identical values, even with similar levels of annual collections. One professional practice may have greater or lower profitability than another as well as other factors that make one practice distinct from another, such as location, square footage, or method of patient payment, for example, fee for service or reduced fees. Similar practice values often are used in destination locations where there is usually high demand by candidates who are looking for practice opportunities where few exist.

Balancing the Tax Effects

Valuations of professional practices are calculated on a tax-neutral basis without regard to whether the retiring professional or purchasing professional receives favorable tax treatment, especially in the sale and purchase of a fractional interest. When one party receives favorable tax treatment and the other does not, the selling and purchase price may be adjusted to make the transaction tax neutral. For example, for the purchase and sale of stock in after-tax dollars, the value may be reduced to reflect the fact that the purchasing professional cannot amortize the purchase price. When the stock excludes goodwill, and a compensation shift is used for the buy-in and deferred compensation for the buy-out, the compensation portion of the purchase price is increased by some percentage of the difference between capital gains and ordinary income to the existing owner and again for an interest component.

Goodwill

Interestingly, professional practice valuations usually do not consider whether goodwill is personal versus corporate. "Personal goodwill" means that the professional "owns" his or her contacts that generate clients or patients. "Corporate goodwill" means that the business entity itself owns the goodwill, through institutional advertising or by noncompete agreements between the entity and the professionals. The analysis of goodwill requires a separate appraisal, and appraisers who will value the nature of the goodwill are difficult to locate, probably because of potential audit concerns. CPAs generally determine to what extent any goodwill is personal versus enterprise or corporate when the professional practice is organized as a C corporation. Most professional practice appraisers do value each category of assets and will place a value on goodwill, but they will not distinguish its character.



Comparison of Buyout Structures		
	Double Taxation S corporation/736(b)	Single Taxation 736(a)
Net Income	$242	$182
Tax to Remaining Professionals	$109	—
Net to Remaining Professionals	$133	—
Tax to Retiring Professional	$ 33	$ 82
Net to Retiring Professional	$100	$100

The Tax Court recognized the concept of personal goodwill separate and apart from corporate goodwill in *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), and *Norwalk v. Commissioner*, T.C. Memo. 1998-279. Factors that indicate personal goodwill rather than corporate goodwill include the absence of a noncompete agreement and the close personal relationships that the owner has developed and maintained with clients. Professionals are more likely to have personal goodwill than other businesses because clients have loyalty to the professional and not to the professional entity.

Corporate Structures

A professional can sell his or her interest to the company (a redemption) or to other professionals (a cross-purchase). A redemption is convenient for centralizing payment and can be easier to implement in a larger professional practice. A cross-purchase tends to generate better tax results when the interest of a deceased professional is purchased using life insurance. Buyouts of professionals who operate in corporate format also can involve payments of deferred compensation.

Corporate Redemption

In a redemption by a corporation, the retiring professional generally is taxed on the extent to which the redemption proceeds exceed the seller's tax basis. IRC §§ 302(a), 1001. A transaction must be a redemption for state law purposes before it might be considered a redemption for tax purposes. IRC § 317(b).

If the retiring professional retains an interest in the corporation, however, or if other family members also retain an interest, the redemption might be considered a distribution rather than a sale of the stock. Family attribution likely will not be an issue unless a family member of the professional is an owner in the professional corporation. IRC §§ 302(b)(2)(C) and 302(c) provide that family attribution can cause redemptions to be treated as distributions that might be taxed as dividends rather than as sales. Thus, what for state law purposes is a redemption is not necessarily treated as a redemption for income tax purposes.

Although qualified dividends (from current or accumulated domestic C corporation earnings and profits) currently are taxed at the same rates as capital gains, taxation of dividends might be less favorable because the recipient of a dividend generally cannot use his or her basis to reduce the gain on sale and would not be able to defer tax if a note is used in the redemption.

Although a corporate redemption may be appealing to a retiring professional because of the ability to receive preferable capital gains treatment on buyout, the remaining professionals are unable to deduct the redemption payment to the retiring professional and, therefore, must use after-tax dollars to make the redemption payment, as illustrated in the chart titled "Comparison of Buyout Structures."

Cross-Purchase

In contrast to a corporate redemption, a cross-purchase structure requires the remaining professionals to purchase the interest of the retiring professional. One benefit to the remaining professionals with a cross-purchase is that it allows them to increase their basis in the stock of the corporation by their portion of the purchase price. Shareholder agreements provide flexibility to the corporation and professionals in deciding whether to have the corporation or the other professionals purchase the interest, emphasizing purchases at death being made by the recipient of life insurance proceeds and purchases from business earnings coming from the corporation.

Be aware, however, that a buy-sell agreement might convert what appears to be a corporate redemption into a deemed dividend followed by a deemed cross-purchase. The IRS takes this position if a shareholder has the primary, unconditional obligation to enter into a cross-purchase and the corporation redeems the stock instead. Rev. Rul. 69-608, Situations 1, 2, and 3. The IRS does not take this position, however, if a shareholder has a mere option to cross-purchase, if a shareholder's purchase obligation is contingent on

the corporation not redeeming the stock, if a shareholder has the right to assign the purchase obligation to the corporation, or if the agreement is amended before a shareholder's purchase obligation became unconditional. Rev. Rul. 69-608, Situations 4, 5, 6, and 7, respectively.

Consider Alternative Minimum Tax on C Corporations

Life insurance often is used to provide funding for a buyout. Care should be taken if the life insurance is to be owned by a C corporation. Life insurance proceeds received by a C corporation (but not an S corporation) can be taxed under the corporate alternative minimum tax (AMT) because insurance proceeds increase a corporation's book earnings but are not included in the taxable income of the corporation. IRC § 56(g).

AMT does not apply, however, to C corporations whose average annual gross receipts do not exceed a threshold, which is $7.5 million over any post-1993 three-taxable-year period (or portion thereof) of the corporation. Also, average annual gross receipts for the first three-taxable-year period cannot have exceeded $5 million. IRC § 55(e)(1).

Redemptions or Distributions Involving S Corporations

If the corporation has an S election in place, then taxation as a distribution generally is more favorable in that distributions generally reduce basis, without any part of the distribution being treated as gain on the sale of stock because distributions are allocated first to S corporation earnings, which are tracked in an accumulated adjustments account (AAA). IRC § 1368; Rev. Rul. 95-14. Life insurance and other nontaxable income, however, will increase stock basis but will not increase the AAA. IRC § 1368(e)(1). Conversely, premiums paid on life insurance owned by the S corporation do not reduce AAA. Rev. Rul. 2008-42. If the S corporation has prior C corporation earnings and profits (E&P), then a distribution in excess of AAA will constitute a taxable dividend to the extent of E&P rather than merely being applied against the basis acquired by that life insurance or other nontaxable income. IRC §§ 1368(c)(2), 301(c).

Once a distribution has exhausted AAA and any E&P, the distribution is applied first against basis and then constitutes capital gain. IRC § 1368. In corporations with accumulated C corporation earnings and profits, a professional may consider electing to treat the distribution *first* as a dividend coming from C corporation earnings and profits. IRC § 1368(e)(3).

If the professional corporation has an S election in place and is using life insurance to fund a redemption, it is better to have the policy owned outside of the corporation to allow the remaining shareholders to fully increase basis in their stock by the amount of insurance proceeds, which allows them to access excess cash without worrying about triggering dividend treatment if the corporation has E&P.

When an S corporation redeems stock under IRC § 302(a) or 303(a), the following results occur:

- AAA is reduced by an amount equal to the AAA multiplied by the number of shares redeemed and divided by the number of shares of stock in the corporation immediately before the redemption. IRC § 1368(e)(1)(B); Treas. Reg. § 1.1368-2(d)(1)(i).
- E&P is reduced by a ratable share of post-February 28, 1913, E&P. IRC § 312(n)(7), superseding the limitations of Treas. Reg. § 1.312-5. Rev. Rul. 79-376, which had governed in the situation, was made obsolete by Rev. Rul. 95-71, presumably in response to this change. The Senate Report to Pub. L. No. 98-369 that enacted the current statutory language provides: "In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption."
- These reductions in AAA and E&P are independent of each other. Treas. Reg. § 1.1368-2(d)(1)(iii).

If an S corporation is a former C corporation with significant E&P, then a disadvantage of a redemption relative to a cross-purchase exists because AAA is reduced in a redemption, whereas AAA is not affected in a cross-purchase. (This could be an advantage if the goal is to cleanse the corporation of E&P to avoid the passive investment income rules, but these rules are easy to work around by investing in oil and gas partnerships, the gross receipts of which count as nonpassive income under Rev. Rul. 71-455, which is explained in PLR 200928024 and other rulings.)

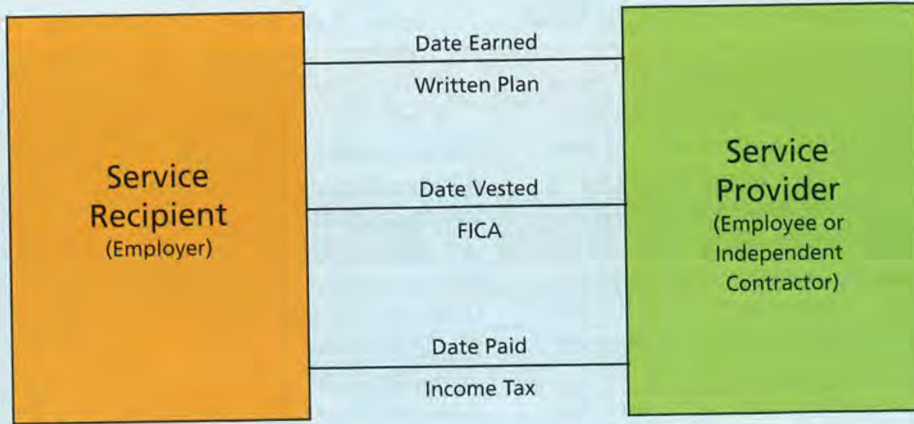
Once the professionals determine an appropriate structure for a buyout, they then must determine the amount and timing of payments.

Payment Options

A lump-sum payment maximizes the retiring professional's financial security because the payment is received up front, but the lump-sum payment accelerates income taxation. A lump-sum payment, other than in the case of a professional's death when life insurance is used to fund a buyout, likely will require third-party financing.

A deferred compensation arrangement places more financial risk on the retiring professional because the payments will depend on the continued success of the practice. The retiring professional also will recognize ordinary income on receipt of the payments, but the remaining professionals will receive a deduction for payments made to the retiring professional, enabling them to pay more to the retiring professional. This higher payment received by the retiring professional can more than make up for the higher tax rate he or she faces.

Enacted by the American Jobs Creation Act of 2004, IRC § 409A imprints a new layer of rules, which supplement previously existing rules on taxing deferred compensation. The new statute punishes service providers (employees and independent contractors) who receive deferred compensation without



Date Earned. Need to have written plan in place before service provider obtains legally enforceable rights—either required or best practice to be in place before performing service.
Date Vested. "Vested" corresponds to no further obligation to perform services. FICA will be due on present value. Treas. Reg. § 31.3121(v)(2)-1(c)(2).
Date Paid. Income tax is due when paid or constructively received, but FICA is not due because it was already paid. IRC § 409A places strict limits on events that accelerate payment and events that delay payment.

complying with its terms. The service provider must pay a penalty of 20% of the deferred compensation when it is includable in gross income. IRC § 409A(a)(1)(B)(i)(I); Prop. Treas. Reg. § 1.409A-4. At the same time, the service provider also must pay interest to the IRS on the deferred tax, measured from the taxable year that is the later of when compensation was earned or when it was not subject to a substantial risk of forfeiture. IRC § 409A(a)(1)(B)(i)(II); Prop. Treas. Reg. § 1.409A-4.

Permissible triggering events for payments under IRC § 409A include separation from service, disability, death, a specified time or fixed schedule, a change in control of the service recipient, or an unforeseeable emergency. Special rules apply to split-dollar life insurance arrangements that were entered into before 2005. Notice 2007-34. Under IRC § 409A, one is required to have a written plan in place as soon as a legally binding right to nonqualified deferred compensation exists. The written plan must be in place when the service provider obtains a legally binding right to the compensation. Treas. Reg. § 1.409A-1(a)(1).

Partnership Structures

The partnership tax rules afford great flexibility in allowing partners to structure their economic arrangement and permit individuals to form partnerships or be admitted to existing partnerships in exchange for cash, property, or services, or some combination thereof, on a tax-free basis, subject to certain exceptions. It generally is much easier to contribute assets, particularly assets subject to liabilities, to partnerships on a tax-free basis than it is for shareholders to contribute encumbered assets to a corporation. Contrast IRC §§ 721 and 752 (partnerships) with IRC § 357 (corporations).

The buyout of a retiring professional's interest can be structured as a redemption of the retiring professional's interest by the partnership or as the purchase of the retiring professional's interest by the other professionals. Redemption by the partnership can offer tax planning opportunities not available with a purchase of the interest by the other professionals. The redemption also offers the benefit of administrative ease if the practice has a large number of professionals.

IRC § 731 governs the tax treatment of distributions from a partnership to a partner and generally provides that a partner will recognize gain to the extent that "money" exceeds a partner's basis in the partnership. Most buyouts of a retiring professional likely will involve cash payments to the retiring professional over some period of time. If partnership assets are distributed to the retiring professional as part of the buyout, the anti-mixing bowl provisions of IRC §§ 704(c)(1)(B) and 737 will need to be analyzed if the retiring professional contributed appreciated property to the partnership within seven years of redemption. (Also note that marketable securities are treated as "money" for purposes of IRC § 731 and thus may not be distributed income tax free unless certain exceptions apply.)

IRC § 736

IRC § 736 governs the treatment of payments made to a retiring partner, a deceased partner's estate, or a successor in interest. IRC § 736(a) provides that payments may be deductible to the partnership and ordinary income to the retiring partner. If and to the extent that these payments are based on partnership income rather than being fixed, however, they constitute a shifting of a distributive share of partnership income to the retiring partner, rather than a deduction to the partnership and income to the retiring partner. In contrast, IRC § 736(b) provides that payments to a retiring partner are nondeductible to the partnership in the year of payment (although possibly depreciated or amortized) and are considered capital gain to the retiring partner, subject to IRC § 751(b).

If asked if they would rather receive buyout payments subject to ordinary rates or capital gains rates, most retiring professionals would choose to structure their redemption payments under IRC § 736(b) to provide for capital gain treatment. As the discussion below illustrates, however, structuring redemption payments under IRC § 736(a) with ordinary income tax rates can provide greater after-tax proceeds to the retiring professional and a tax benefit to the other professionals.

Within certain limits, the redemption agreement can provide for as much or as little of the redemption

payments to receive treatment under IRC § 736(a) or (b). But because IRC § 736(b) payments cannot exceed the fair market value of the withdrawing partner's share of the partnership property, IRC § 736(a) must apply to such excess.

Also, if capital is not a material income-producing factor for the partnership and when the retiring or deceased partner was a general partner in the partnership, IRC § 736(b) cannot apply to the extent of the partnership's unrealized receivables and goodwill, except to the extent that the partnership agreement provides for a payment with respect to goodwill.

If payments cannot be classified as IRC § 736(b) payments, then they must be IRC § 736(a) payments. The above limitation on what constitutes IRC § 736(b) payments means that such payments must be classified as IRC § 736(a) payments. It does not mean that such payments are the only types of payments that can be classified as IRC § 736(a) payments instead of IRC § 736(b) payments. See "Comparison of Buyout Structures" on page 40.

Suppose, however, that the partnership agreement provides for an IRC § 736(b) payment with respect to goodwill. Each IRC § 736(b) installment would give rise to a new goodwill asset that could be amortized over 180 months. Thus, the parties could get some tax advantage, with the buyer receiving ordinary deductions over 15 years and the seller receiving capital gain.

IRC § 736 payments defer the recognition of gain on sale relative to installment sales, a benefit that is not present in the sale of stock in a C or an S corporation.

Main Points

- Under a capital gain IRC § 736(b) scenario, taxes consume much more of the payment as a whole than would the ordinary income IRC § 736(a) scenario in meeting the targeted payments of "principal." Thus, the ordinary income scenario provides more money that is available to buy out the seller and eases the stress of the buyout.
- To compensate the seller for a higher ordinary income tax rate, the seller must receive more to generate the same after-tax flow. Thus, while the stated sales price would appear to be higher and more burdensome, in reality the buyer is better off because deducting the payments saves more than the additional purchase price cost.
- In the IRC § 736(a) scenario, increases in ordinary income tax rates harm the retiring professional disproportionately, although it might be possible for the buyer to agree to pay more because the buyer saves more tax by making those additional payments. On the other hand, in a capital gain scenario, an increase in capital gain rates without a corresponding increase in ordinary income rates would not help the buyer save as much tax by paying the retiring professional more.
- IRC § 736(a) requires a complete liquidation of the redeemed partner's interest. The complete redemption, however, may be made over time. If the partnership assumes the partner's share of liabilities, it cannot deduct the payment of those liabilities under IRC § 736 later than the year in which the partner's relationship with the partnership terminated.
- The above treatment does not apply to the extent that the partnership is repaying the retiring professional's capital account. Generally, the retiring professional's capital account would be equal to the partnership's earnings that were allocated to the retiring professional but not distributed. The retiring professional would not be taxed on such distributions because they were taxed when originally earned.

IRC § 736 taxes the retired partner on IRC § 736 payments as if the retired partner were still a partner. IRC § 736(a) payments are taxed in the year for which they are made, rather than in the year of receipt. Furthermore, except to the extent IRC § 751(b) applies, the amount of any gain or loss with respect to payments under IRC § 736(b) for a retiring or deceased partner's interest in property for each year of payment is determined under IRC § 731. Thus, the installment sale rules do not appear to apply to IRC § 736 redemptions. This also means that, rather than basis being prorated among the scheduled installment payments the way an installment sale would work, basis is applied fully to the earliest payments until it is used up. Thus, IRC § 736 payments defer the recognition of gain on sale relative to installment sales, a benefit that is not present in the sale of stock in a C or an S corporation.

Conclusion

Careful analysis and planning are required to structure a buyout of a professional's interest in his or her practice. The choice of entity will have an effect on the buyout structure and tax efficiency, and professionals with existing entities may need to consider restructuring entities to facilitate retirement. For professionals forming a new entity, the best time to address the buyout is on the formation of the entity, even though many professionals are hesitant to do so. ■