

Quarterly Supplement To

Business, Legal, And Tax Planning for the Dental Practice

Second Edition

The purpose of the Quarterly Supplement is to continually update the material contained in **Business, Legal, And Tax Planning for the Dental Practice**, Second Edition, as "free-standing" articles relative to current business, legal, tax and pending legislative matters that affect your practice. These Quarterly Supplements also reflect my ongoing experiences as an attorney representing dental and dental specialty practices. At times, articles will be written by friends who consist of tax attorneys, accountants, actuaries and dentists. The articles contained in the Quarterly Supplements are consistent with the chapters contained in my book, which you may download at no charge at www.wickenslaw.com — click Dental Law.



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Co-Ownership — Minimizing Your Tax Risks

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CO-OWNERSHIP — MINIMIZING YOUR TAX RISKS

Practices consisting of two or more owners are becoming more common as a practice exit and entry option¹ as the number of practices that grow and then expand or relocate increase. As a result, the reader, be it the doctor, non-doctor spouse or advisor(s), should be aware of little known but very important tax risks that may be implicated under the basic business and tax structures relative to co-ownership.²

Each of these business and tax structures consists of three categories. They are the associate buy-in, the owner buy-out, and operations.³ All categories need to be considered when co-ownership is contemplated, hopefully prior to an associate picking up a handpiece. Why? Because if the practice owner's succession or exit strategy is definitive and a new doctor is to be admitted as a future partner, the identity of the candidate will not matter. Dealing with these complex issues a year or two after the associateship begins often leads to disagreements over the purchase price, valuation date, and business and tax structure.

PURCHASE AND SALE OF STOCK IN AFTER-TAX DOLLARS

One 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, the purchaser pays income tax on all compensation earned and then pays for the stock in after-tax dollars, while the seller pays tax as capital gains on the sale of the stock. Therefore, all taxes are accounted for, and the purchaser, the seller and the practice entity are free from IRS scrutiny in the event of an audit. There is an additional, but delayed, tax benefit for the purchaser under this structure. When the incoming owner later sells the stock, capital gains are paid only above the purchase price previously paid or the "basis" in the stock.

If it appears that this business and tax structure will not work because the economics will not allow it, a solution is to balance the tax benefit to the seller with the tax detriment to the purchaser by adjusting the tax-neutral purchase price downward.

¹ "Ready, Set, Retire!" Dental Economics, Dr. James R. Pride and William P. Prescott, M.B.A., J.D., PennWell Corporation, July, 2001.

² A panel discussion on this topic, which I organized, was sponsored by the Closely Held Businesses Committee of the American Bar Association, Section of Taxation, on May 8, 2009. I was a member of that panel, which also included a Small Business/Self-Employed representative from the Internal Revenue Service ("IRS"). I was also part of a similar discussion on the same topic while on a similar panel, which I also organized, for the American Bar Association at its Annual Meeting on July 31, 2009.

³ 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.

STOCK EXCLUDING GOODWILL

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, which involves the senior owner providing management and administrative services to the professional corporation and being compensated for these services under a practice management agreement. As a result, the new owner's interest in the practice is increased by the compensation adjustments for the value of the non-professional services provided by the senior owner.

It is important to note that the compensation shifted to the senior owner must equal the value of the non-professional services rendered.⁴ The incoming owner's compensation is then reduced by the sum of the management fees that the practice pays to the senior owner, resulting in the incoming owner receiving a disproportionately lesser amount of compensation than the senior owner during the first several years of the co-ownership.

Although some authority exists that gives some support for the use of a compensation shift,⁵ there are no Tax Code Sections that allow for a compensation shift as a means for the purchase and sale of an interest in a closely held business or professional practice.

Although compensation shifts have not yet presented tax problems in the buy-in piece of the transaction, assuming that the management fees equate to the management services provided, problems may arise in the buy-out.

Tax Complications of Deferred Compensation in a Buy-Out

Sometimes buy-outs are structured with stock being purchased by the professional corporation at a low value, often the fair market value of the professional corporation's tangible assets, coupled with the payment of deferred compensation by the professional corporation,⁶ without the inclusion of goodwill. Payments for deferred compensation are deductible to the professional corporation. However, any deferred compensation is ordinary taxable income to the recipient.

Moreover, deferred compensation arrangements, including the payment for accounts receivable, are now subject to the complexities of IRC Section 409A, and the agreements must be drafted in accordance with its regulations. Additionally, IRC Section 1060(e) may impose future informational reporting requirements for deferred compensation and similar arrangements.

⁴ Pediatric Surgical Associates, P.C. v. Commissioner, T.C. Memo 2011-81, April 2, 2001.

⁵ Tax Planning For Corporations and Shareholders, Second Edition, Zolman Cavitch, Lexis Publishing, Matthew Bender & Company, Inc., 13.04[1], [2], [3].

⁶ Revenue Ruling 60-31.

Finally, the Treasury Regulations require that a "Top Hat Exemption Form" be filed with the Department of Labor within 120 days after any deferred compensation agreement is signed.⁷ Failure to file the Top Hat Exemption Forms results in penalties and failure to comply with IRC Section 409A results in the immediate taxation of all deferred compensation, plus a 20% penalty on the entire sum of the deferred compensation.

Personal Goodwill

There are advantages when the stock of the departing shareholder is redeemed or purchased by the professional corporation at a low value without goodwill but is coupled with the professional corporation's purchase of the departing shareholder's personal goodwill, a business and tax structure supported by case law.⁸ To the extent that there is personal goodwill, the purchaser, which is the professional corporation, is able to amortize the personal goodwill over 15 years while the purchase of stock cannot be amortized.⁹ To the retiring or departing owner, the personal goodwill may, 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. If personal goodwill is part of the transaction, the shareholder being bought out cannot have been subject to a restrictive covenant with the practice.¹⁰ This point alone effectively eliminates this common business and tax structure. The prohibition of non-competition provisions is irrespective of whether the entity is a C-corporation or S-corporation. For example, if the entity is a C-corporation, the goodwill is double taxed at 35% at the corporate level and again at 15% at the individual level. If it is an S-corporation, there could be a termination of the S election due to a disproportionate distribution and redemption of stock resulting in a purchase by the professional corporation of the stock of the departing shareholder in after-tax dollars. If this approach is used, it is important to have an appraisal that distinguishes the personal goodwill of a retiring or departing owner versus any corporate goodwill. The appraisal results of the personal goodwill would be included in the buy-sell agreement formula. Unfortunately, few appraisers will prepare this special type of appraisal.

Interestingly, we are now dealing with buy-outs where doctors who own practices that purchased personal goodwill are retiring. In these buy-outs, there will be depreciation recapture for amortization previously taken for personal goodwill earlier purchased at ordinary income

⁷ Labor Reg. 2520.104-23.

⁸ The following Technical Advice Memorandum and Revenue Ruling recognize the partial transfer of personal goodwill: TAM 200244009; Revenue Rule 70-45.

⁹ 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.).

¹⁰ *Martin Ice Cream v. Commissioner*, 110 T.C. No. 189 (1998); *Norwalk v. Commissioner*, T.C.N. 1998-279.

rates.¹¹ The effect of any depreciation recapture should be calculated for any transaction that involves or will later involve this issue.

THREE ENTITY APPROACH

An increasingly common business and tax structure for co-ownership is for the incoming owner to form an S-corporation and purchase an undivided one-half interest in the assets from the existing practice entity or owner. Advisors attempt to get amortization to the new owner through the purchase of assets and mostly capital gains to the existing owner because roughly 85% to 88% of an asset purchase and sale is allocated to goodwill. After the purchase, the new and existing owner operate the practice through a newly-formed limited liability company or partnership¹² that collects the revenue, pays the operating expenses including employee benefits and employs the staff. Profits are distributed to the entities owned by the respective shareholders or doctors individually if there are no professional corporations. Each doctor owned entity, e.g., an S-corporation, pays the direct business expenses of each member or partner, which may include liability insurance, continuing education, business travel, automobile, possibly technology used only by one owner, lab and/or any other direct business expense that may be disproportionate for one or more of the owners. General operating, staff, and occupancy expenses are usually paid pro rata, e.g., 50%/50% in a two owner practice. It should be noted that this approach may also include use of a compensation shift with the ramifications earlier discussed.

This business and tax structure carries the complexity of operating with three entities, along with the preparation of three tax returns. However, because the new owner does not purchase an interest in the existing owner's entity, there is no concern over the purchaser being subject to unknown or contingent liabilities. While this approach can work very well if the practice has engaged an accounting firm with experience in these types of business structures, there are other important issues to deal with.

Anti-Churning Rules

Unfortunately, if the practice was formed prior to August 10, 1993, the buy-in and buy-out under the three entity approach as well as the professional corporation's purchase of the personal goodwill is subject to the IRC Section 197 Anti-Churning Rules.¹³ The Anti-Churning Rules deny amortization of the goodwill purchased by the incoming owner¹⁴, if the existing and new owner jointly own twenty percent or more of the third entity¹⁵ or are family members. It is the third entity, the limited liability company or partnership that creates the problem for

¹¹ IRC Section 1245(b)(9)(A).

¹² Dental and dental specialty practices are not permitted to practice as limited liability companies in California or Hawaii. Thus, partnerships are utilized as the practice entity under this business and tax structure.

¹³ The Tax Advisor, September, 2009, 9-09, T.T.A. 573, Thomas J. Brecht, Elkhart, IN.

¹⁴ IRC Section (f)(9)(A)(i); IRC Reg. 1.197-2(h)(2)(i).

¹⁵ IRC Reg. 1.197-2(h)(6)(i)(A).

non-related owners. IRC Section 197 does not provide for bifurcation of the goodwill for pre and post-August 10, 1993.¹⁶ 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 8594 that must be filed by both seller(s) and purchaser. In addition, under its Anti-Abuse Rules, the IRS may interpret and apply the rules under IRC Section 197 as necessary and appropriate to prevent avoidance of the purposes of IRC Section 197.¹⁷ Therefore, there is authority for the IRS to recast the transaction.

A possible way, but not one without risk,¹⁸ to avoid the application of the Anti-Churning Rules is for the practice to form an affiliate at least one year prior to the buy-in. For example, in a one owner practice, the practice entity transfers its tangible assets and the practice owner transfers his or her personal goodwill to a newly formed limited liability company or partnership. The limited liability company or partnership makes what is called an IRS Section 754 election and, at least one year later in an unrelated transaction, the senior owner sells an interest to the new owner.¹⁹ In an existing two owner practice that operates as a limited liability company or partnership, the IRC Section 754 election would also be made in the same manner.

If, on the other hand, the owners operate separate practices under a solo group arrangement with no common ownership of a third entity, the goodwill is amortizable for the buy-in, 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 the new owner is usually not required to purchase the existing owner's practice at retirement or other departure but retains the option to do so. Because the practices are separate, the retiring owner can sell his or her practice to a third party dentist if the remaining owner does not exercise the option to purchase. Death or permanent disability, however, usually requires a mandatory purchase.

S-Corporation Distributions

Where the members of a limited liability company or partnership are S-corporations, which is relatively common, another problem with the three entity approach arises relative to S-corporation distributions, which have the effect of eliminating the 2.9% Medicare tax above the Social Security wage base. Some advisors prefer a limited liability company or partnership of S-corporations so that S-corporation distributions can be taken. Note that the IRS dislikes S-corporation distributions to begin with and believes that this practice is being abused. Where the three entity approach is used and the operating entity is a limited liability company, there is

¹⁶ Mergers, Acquisitions, and Buyouts, Martin D. Ginsburg, Jack S. Levin, December, 2002, Aspen Publications, 4-118, Example 17, Section 403.4.4.4.

¹⁷ IRC Reg. 1.197-2(j).

¹⁸ Footnote 461, Section 9.02[3][k], *Federal Taxation of Partnerships and Partners*, McKee, Nelson and Whitmire, Fourth Edition, Thompson Reuters.

¹⁹ IRC Reg. 1.197-2(k) Ex. 19.

authority²⁰ to suggest that the S-corporation distributions are unavailable and that all income flowing through the limited liability company is self-employment income, irrespective of the reasonableness of the distributions.

Worker Classification

It is not uncommon for a limited liability company or partnership with S-corporations as members or partners to structure the transaction with the S-corporations as independent contractors to the limited liability company or partnership. While a panelist on this topic²¹, the question discussed was whether the new associate, retiring doctor or doctors or corporations under the three entity approach could qualify as independent contractors. In all three instances, the conclusion was rarely. Where the practice bills the patients, sets and collects fees and schedules patients, and where the doctors are subject to restrictive covenants, there is probably sufficient behavioral control, financial control and relationship of the parties for an employer/employee relationship, irrespective of whether the doctors practice through S-corporations or another entity.

A related question often asked by consultants is, "If the independent contractor pays its applicable taxes and the limited liability company or partnership pays its applicable taxes, no harm no foul, right?" The answer is "no". If there is a misclassification, the employer would be assessed all federal income tax, penalties and interest with limited ability to get the funds back considering that the same tax cannot be collected twice. For the employee, those direct business expenses and benefits would, for the most part, be lost.

It is clear that worker classification is once again becoming a priority of the IRS and the states relative to small businesses and professional practices. Thus, independent contractor relationships are not advisable in the three entity approach or in the other situations.

SUMMARY AND THOUGHTS

Remaining a solo practitioner is best, and practicing in a solo group, second best. If co-ownership is entered into, 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. 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. However, the three entity approach does work well if the practice was formed after August 10, 1993, and the owners are unrelated, notwithstanding the complexity and increased accounting costs of operating three entities.

²⁰ The Tax Advisor, February, 2003, 2-03 T.T.A. 80, American Institute of Certified Public Accountants, Inc., Thomas P. Ochsenschlager, Partner, Grant Thornton, LLP, Washington, D.C.

²¹ In August, 2008, I participated in the first IRS Office of Chief Counsel Program in Atlanta, along with four IRS representatives on worker classification. The participants were the approximately 1,200 IRS lawyers.