

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.PrescottDentalLaw.com.



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Co-Ownership — The Roadmap!

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CO OWNERSHIP — THE ROADMAP!

In Co-Ownership — a taxing relationship, September, 2010 Issue, I described four tax risks in co-ownership. They are compensation shifts, deferred compensation, personal goodwill and the anti-churning rules.¹ This article delineates how associate buy-ins and owner buy-outs should be structured in light of the four very real tax risks under specified fact patterns. Unless indicated otherwise, each fact pattern involves two owners, Dr. Senior and Dr. Junior.

Unrelated Parties, Practice Formed Prior to August 10, 1993.

Solo Group Arrangements.

Under the increasingly popular three entity method, a partnership of corporations, the anti-churning rules² deny amortization or deductibility of the goodwill purchased for both Dr. Junior's buy-in and your buy-out if your practice was formed prior to August 10, 1993. This is due to the common ownership of a third entity. This is important because at least 85% of the purchase price for an associate buy-in or owner buy-out is goodwill, which is taxed to you as capital gains. A very good alternative is to form a solo group, whereby your practice and Dr. Junior's practice operate separately under an office-sharing agreement. The solo group allows the purchase of goodwill by Dr. Junior to be deducted for the purchase of the first half of your practice because there is no common ownership of a third entity. There is also not a problem with deductibility of goodwill for the purchase of the second half by Dr. Junior or another dentist. Solo groups work well because Dr. Junior may not desire to purchase the second half of your practice, a big problem in co-ownership.

While a buy-sell agreement could provide for the mandatory purchase by Dr. Junior, the purchase is usually optional. However, in the event of the death or disability of you or Dr. Junior, a buy-out is usually mandatory. The buy-sell agreement would also provide that your practice remains in the facility if a dispute with Dr. Junior should arise and would further provide for the re-purchase, at the then fair market value, of any equipment or technology that you and Dr. Junior own together. Most importantly, you get paid in cash without guaranteeing Dr. Junior's or the third party's loan. Because lenders will not grant loans for a fractional interest in equipment, you divide it almost equally, e.g., you get the air compressor, Dr. Junior (or Dr. Junior's practice entity) buys the vacuum, you get two treatment rooms, Dr. Junior buys two treatment rooms, you get one hygiene treatment room and Dr. Junior buys the other. Dr. Junior does purchase a fractional interest in your goodwill, for which a lender will lend. Additional benefits of a solo group are that each practice may maintain its own retirement, health and fringe benefit plans, and can still share employees to the extent you jointly choose, e.g., hygienist(s).

¹ These risks were confirmed at the American Bar Association, Section of Taxation Meeting, Toronto, Canada, September 24, 2010 in a panel with IRS Assistant Division Counsel, Small Business, and me.

² Internal Revenue Code Section 197(f)(9).

Purchase and Sale of Stock In After-Tax Dollars.

The purchase and sale of stock, inclusive of tangible assets and goodwill in after-tax or non-deductible dollars, works well. However, the purchase price for the first half of your practice and buy-out formula for the second half must be reduced to equate to a deductible asset sale. Otherwise, Dr. Junior cannot afford to make the purchase. This percentage reduction is nearly 20% and you receive capital gains. Usually, the buy-in is internally financed because Dr. Junior's lender will require a guarantee from your practice and/or you to obtain a loan for the purchase the first half. The buy-out in a two owner practice can be payable in cash because Dr. Junior, as the sole remaining shareholder, can obtain financing without your guarantee.

In a practice with two or more owners, a third owner usually, but not always, purchases the second half. Here, Dr. Junior would not want to be affected by your buy-out by the third owner. This means that Dr. Junior would not be willing to guarantee the loan for your buy-out, so the buy-out by a third owner would usually be internally financed.

Stock Excluding Goodwill, Coupled with Compensation Shift and Deferred Compensation.

Compensation Shift Buy-In. The stock of your corporation purchased by Dr. Junior could be valued to equal the fair market value of tangible assets and excluding goodwill. The goodwill for the buy-in would be payable to you by your corporation through management fees in exchange for your provision of management services or a compensation shift. This method has not yet presented a problem for associate buy-ins. However, if you practice through a C-corporation, there could be a reallocation upon audit of the management fees as unreasonable compensation.³ If you plan to use this method for the associate buy-in, make sure that your corporation issues a meaningful dividend and maintain a log of the management services you provide to ensure that they equate to the value of the management fees. Here, Dr. Junior's compensation is reduced by the management fees paid by your corporation to you over five or seven years. The relatively low stock or tangible assets purchased by Dr. Junior would be made in non-deductible dollars and paid over the same time period as the corporation's payment of the management fees to you. Because you receive ordinary income for the management fees, as opposed to capital gains, the sum shifted to you is usually increased by the tax differential between ordinary income and capital gains and again for an interest component.

Deferred Compensation Buy-Out. The stock value purchased by Dr. Junior or the corporation would again exclude goodwill. The payment for your goodwill would be made by your corporation's payment of deferred or continued compensation to you. While deferred compensation buy-outs are workable, the complex requirements of Internal Revenue Code ("IRC") Section 409A must be complied with. This creates difficulties for payment of accounts receivable and requires a separation from service. The separation from service means that you cannot continue to work after you are no longer a shareholder on a full-time basis and receive the

³ *Pediatric Surgical Associates, P.C. v. Commissioner*, T.C. Memo 2011-81, April 2, 2001.

deferred compensation at the same time. Deferred compensation payments may also not be accelerated. Failure to comply with the harsh requirements of IRC Section 409A results in the immediate taxation of all deferred compensation, plus a 20% penalty. The biggest problem with these buy-outs is that you are paid over time instead of being paid in cash. Because you receive ordinary income instead of capital gains on deferred compensation, the sum is usually increased to reflect the tax differential to you and again for an interest component.

Unrelated Parties, Practice Formed After August 10, 1993.

Provided that the practice was formed after August 10, 1993, there are two additional business and tax structures available.

Stock Excluding Goodwill, Coupled With Buy-Out of Personal Goodwill.

For the buy-in, the stock value would exclude goodwill and compensation would be shifted to you. For the buy-out, instead of the corporation's payment to you of deferred compensation over time, the corporation would purchase your personal goodwill in cash in a two owner practice. The corporation purchases your personal goodwill, as opposed to Dr. Junior, because it is the business and the business, not Dr. Junior, deducts the goodwill over 15 years. The purchase of your personal goodwill is arguably taxed at one level to you and at capital gains rates. However, if this buy-out method is used, you cannot be subject to a restrictive covenant with either your C or S-corporation, nor can there be a written promise with your corporation or Dr. Junior that you will be a party to a restrictive covenant after your buy-out. Would not Dr. Junior require you to be subject to a restrictive covenant? Would you not want Dr. Junior to be subject to a restrictive covenant? Of course! This point should eliminate this buy-out method. Moreover, if your corporation was formed prior to August 10, 1993, the anti-churning rules apply and the corporation's purchase of your goodwill is not deductible.

Three Entity Method.

If your practice was formed after August 10, 1993, the goodwill purchased by Dr. Junior is deductible for both the buy-in and buy-out as an asset purchase. Like a solo group, Dr. Junior forms an S-corporation and purchases one-half of the tangible assets from your practice. Dr. Junior also purchases an undivided interest in your goodwill. You and Dr. Junior form a limited liability company or partnership (a third entity) that bills the patients, pays operating expenses, employs the staff, adopts the retirement, health and fringe benefit plans and then distributes the profits to your respective corporations. Note that the purchase of the first half of the practice will probably be internally financed (unless you act as a guarantor) and may also involve a compensation shift.

Usually, each doctor-owned corporation, as opposed to the third entity, retains its own tangible assets and each entity or each of you retain your or Dr. Junior's newly-purchased goodwill. However, new equipment and technology is usually purchased or leased by the third entity. As such, there would be buy-sell agreements among the corporations, you and Dr. Junior

for both tangible assets and your goodwill. Under the three entity method, the restrictive covenant problem as it relates to the purchase of goodwill is inapplicable because you and Dr. Junior are not co-shareholders of your corporation. In a two owner practice, the buy-out would be payable to you in cash, although we still have a possible problem with Dr. Junior not wanting to purchase the second half of your practice.

Family Members, Practice Formed Prior to August 10, 1993.

Family members are not treated fairly under the tax laws for practices formed pre-August 10, 1993. Not only do the anti-churning rules deny deductibility under the three entity method, but also to a solo group arrangement and a complete purchase and sale. Not fair, but better to know than not know!

For family members, we can use a purchase and sale of stock in non-deductible dollars and reduce the buy-in and buy-out price to equate to an asset sale. As an alternative, Dr. Daughter can purchase stock at a low value excluding goodwill, coupled with the payment of the corporation's deferred compensation over five or seven years to Dr. Dad. If the practice was formed after August 10, 1993, we have no anti-churning rule problem denying the deductibility of goodwill.

Summary and Thoughts.

Complex — yes, so share this information with your advisors, along with Co-Ownership — a taxing relationship, Dental Economics, September, 2010. It is wiser to avoid rather than to take the risks!