

# Compensation-based buy-ins to C corporations

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**A RECENTLY FILED TAX CASE<sup>1</sup>** reinforces previous findings of the Internal Revenue Service (IRS) that advisors seemingly have forgotten about: If the shareholders of a C corporation receive profits not generated by their own professional or other services, those profits can be recharacterized as unreasonable compensation to the shareholders.<sup>2</sup>

The case involved a law firm that paid out all profits to shareholders. It referenced the opinions of two previous cases. The first involved a pediatric medical practice where the shareholders earned profits from the associates' efforts. The second involved an accounting firm where consulting fees paid to entities owned by the firm's founding shareholders were deemed as unreasonable compensation. A common element of these three cases involving professional practices was that the shareholders received profits from the efforts of others rather than through the shareholders' own efforts.<sup>1</sup>

## WHY ARE COMPENSATION-BASED BUY-INS A PROBLEM FOR C CORPORATION PRACTICES?

C corporations are the only entities taxed at the corporate level, which means that nondeductible dividends are taxed at 35% and again at 20% when distributed at the individual level. Compensation-based buy-ins are risky for those practices operating as C corporations because Dr. Senior may be receiving profits generated by Dr. Junior, but not through Dr. Senior's own efforts. What is thought to be a tax-deductible compensation shift in a compensation-based buy-in may be recharacterized as unreasonable compensation, resulting in nondeductible dividend treatment.

## HERE'S HOW COMPENSATION-BASED BUY-INS WORK

Let's look at how this concept works using Dr. Senior and Dr. Junior: After a practice value is calculated, Dr. Junior purchases a pro rata percentage of a combination of stock and goodwill (e.g., Dr. Junior buys 50% in a two-shareholder practice, 33% in a three-shareholder practice, etc.). The stock value is a pro rata fair market value of tangible assets of the practice (and sometimes less). The pro rata value of the goodwill of the practice is paid by the practice operating as a C corporation as additional compensation to Dr. Senior

over five or seven years through a compensation shift. Dr. Junior's compensation as a newly-admitted shareholder is reduced by the full sum of the compensation shift to Dr. Senior over the same period it's paid.

Typically, the value of a dental or specialty practice represents up to 25% tangible assets and at least 75% goodwill. Because goodwill represents, by far, the largest percentage of the practice value, the compensation shift is extremely beneficial to Dr. Junior in that it represents a pretax buy-in. The smaller percentage of the practice value, the stock, is not deductible to Dr. Junior, although it is taxed as favorable capital gains to Dr. Senior. However, the compensation shift is taxable to Dr. Senior as ordinary income rather than capital gains. For this reason, the dollar amount of the compensation shift is usually "grossed up" to account for the difference between ordinary income and capital gains, and again for an interest component.

## ELIMINATING THE BUY-IN RISK: WHAT WORKS

Consider changing the business tax structure from a compensation-based buy-in to **stock inclusive of goodwill**. Stock inclusive of goodwill is not subject to attack by the IRS. However, the fair market value of the practice must be reduced to reflect the fact that Dr. Junior cannot deduct the purchase of stock while Dr. Senior receives all capital gains. What few understand is that the reduction to the value is the opposite of the "grossing up" to the compensation shift in a compensation-based buy-in.

## ELIMINATING THE BUY-IN RISK: WHAT DOESN'T WORK FOR THE BUY-IN.

Risk is *not* eliminated in cases of **personal goodwill for the buy-in**. Thinking that Dr. Junior can deduct personal goodwill and Dr. Senior receives favorable capital gains, some advisors have advocated Dr. Junior's purchase of personal goodwill for the buy-in. Unfortunately, because Dr. Junior does not meet the requirements to be considered a "trade or business," Dr. Junior cannot amortize or deduct the personal goodwill. In addition, Dr. Junior should require Dr. Senior to have a restrictive covenant with the existing practice, meaning that Dr. Senior does not have personal goodwill, but rather corporate goodwill, double taxed.<sup>3</sup>

Neither is risk eliminated using the **three-entity method**. The three-entry method is a limited liability company or partnership of Dr. Junior's newly-formed S corporation and Dr. Senior's existing C corporation. Due to the necessity of restrictive covenants, Dr. Senior does not have personal goodwill and gets double taxed on its sale. In addition, if the practice was formed prior to August 10, 1993, the goodwill is not deductible.<sup>4</sup>

#### HOW TO MINIMIZE RISK

There are various methods to minimize risk in this area. First, consider **converting to an S corporation**. While there are complexities of converting from a C to an S corporation, it resolves the unreasonable compensation risk.

Second, **pay a meaningful dividend**. None of the three cases referenced above discussed what percentage of profit equates to a meaningful dividend. What is called the "independent investor test" was discussed. Under the independent investor test, the court looks at the

rate of return that a nonpracticing or nonworking owner/investor should expect. In other words, if an independent investor invests in a practice, what should the independent investor expect as a rate of return? A dental-experienced CPA should be able to determine a reasonable, versus de minimis, investment return to satisfy the independent investor test.

#### Third, **authorize preparation of a services agreement with your C corporation**.

An administrative and management services agreement, be it a provision in Dr. Senior's employment agreement or a free-standing agreement, should delineate those nonprofessional administrative and management services that are to be provided by Dr. Senior.

Fourth, **maintain an administrative and management log**. Document the time that you spend on administrative and management services in the form of a time sheet or diary. The administrative and management time should include the date, the amount of time spent, and the services provided. While time-consuming

to maintain, an administrative or management time log shows that the administrative or management services were actually provided by Dr. Senior to minimize the risk of unreasonable compensation from the additional pay under the compensation shift.

#### Finally, **prepare yearly directors' minutes**.

This includes a resolution that the administrative and management services were provided to the C corporation for the prior fiscal or calendar year.

#### THE EXCEPTION FOR BUY-OUTS

Compensation-based buy-ins for those practices operating as C corporations are usually not applicable to shareholder buy-outs. The exception is for more than two shareholder practices where a newly-admitted shareholder buys out a departing or retiring shareholder through a combination of stock and a compensation shift. The newly-admitted shareholder's compensation is reduced by the sum of the deferred or continued compensation as it is paid to the departing share-

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