Co-ownership—what works, what doesn't, and why

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Editor's note:
Did you know? The subject of co-ownership is one of our most frequently queried topics, by new dentists and established dentists alike. This article presents updated and refreshed information on this subject. Search for additional articles on co-ownership on DentalEconomics.com, including previous articles by Mr. Prescott.

THE NUMBER OF DENTAL and dental specialty practices consisting of two or more owners continues to grow. If Dr. Senior is planning to admit Dr. Junior as an owner, both owners need to be aware of the tax risks that the other partner—the IRS—thinks are important under three business and tax structure choices.

Each business and tax structure consists of three categories—the associate buy-in, the owner buy-out, and operations.[1] All categories need to be considered when co-ownership is contemplated. This is because dealing with these complex issues a year or two after the associateship begins may cause disagreements over payment terms, the purchase price, valuation date, and business and tax structure.

STOCK EXCLUDING GOODWILL COMPENSATION SHIFT FOR THE BUY-IN

The purchase and sale of stock, excluding goodwill, for a buy-in to a professional corporation is often the fair market value of the professional corporation's tangible assets. This is sometimes coupled with a compensation shift to Dr. Senior, which represents Dr. Senior's goodwill. In exchange for selling a fractional interest in Dr. Senior's goodwill to Dr. Junior, Dr. Senior receives additional compensation. The sale of stock is characterized as capital gains to Dr. Senior and is nondeductible to Dr. Junior. The additional compensation is characterized as ordinary income to Dr. Senior and represents a pretax buy-in for Dr. Junior. To the extent that these sums are equal, the tax effects are balanced. To the extent that the value of Dr. Senior's goodwill is greater than the value of the tangible assets, the compensation to Dr. Senior is increased to balance the tax differential. In addition, interest cannot be paid on compensation and the sum is usually increased for an interest component.

Although compensation shifts have not yet presented tax problems in the buy-in piece of the transaction,[2] assuming that the compensation shifted equates to the management services provided,[3] a problem does arise in the buy-out. The problem is that Dr. Senior is paid over time in the form of deferred compensation rather than in cash. As a result, there is a risk of default on the unpaid balance.

PERSONAL GOODWILL FOR THE BUY-IN

Rather than using a combination of stock excluding goodwill and a compensation shift, some advisors advocate that Dr. Junior individually purchase an undivided interest in Dr. Senior's goodwill for the buy-in. This method is not feasible because personal goodwill is not deductible to an individual who is not a "trade or business."[4] It is deductible only to the practice.

DEFERRED COMPENSATION FOR THE BUY-OUT

If the buy-in is structured as the purchase and sale of stock excluding goodwill, the buy-out should be structured in the same manner. This means that the professional corporation or Dr. Junior purchases Dr. Senior's stock excluding goodwill. The professional corporation continues to pay Dr. Senior deferred or continuing compensation,[5] which represents Dr. Senior's remaining goodwill.

While payments for deferred compensation are deductible to the practice, they are taxable as ordinary income to Dr. Senior. Moreover, deferred compensation arrangements are now subject to the complexities of Internal Revenue Code (IRC) Section 409A and its harsh penalties for noncompliance. The primary effects to the practice are strict rules on the payment of accounts receivable, and no ability to prepay the deferred compensation. To Dr. Senior, the

buy-out is not payable in cash, but over time with little security. While being paid over time works well if a family member succeeds Dr. Senior, Dr. Senior may want to be more cautious with an unrelated Dr. Junior. However, if there are more than two owners, Dr. Senior's buy-out will probably not be payable in cash unless all remaining owners participate as guarantors, and they probably will not. While one or more of the multiple owner(s) may be obligated or agree to buy-out Dr. Senior, the nonparticipating owner(s) would not want to be affected. However, if the practice buys out Dr. Senior, all remaining owner(s) are affected.

PERSONAL GOODWILL FOR THE BUY-OUT

Another buy-out structure, which is supported by case law,[6] is the purchase of Dr. Senior's stock excluding goodwill by Dr. Junior or the practice, coupled with the purchase of Dr. Senior's personal goodwill by the practice. To the extent that there is personal goodwill,[7] the purchaser, which is the practice and not Dr. Junior, is able to amortize or deduct Dr. Senior's personal goodwill over 15 years, while the purchase of stock cannot be deducted. To Dr. Senior, the personal goodwill should arguably be taxed as capital gains at one level and not double taxed.

Understand that the purchase and sale of personal goodwill is not without problems. First, if personal goodwill is part of the transaction, Dr. Senior cannot be or have a written agreement that he or she will be subject to a restrictive covenant with the practice upon his or her buy-out.[8] This point effectively eliminates the business and tax structure because Dr. Junior will and should require Dr. Senior 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.[9] If this method is used, it is important to have an appraisal that allocates Dr. Senior's personal goodwill versus corporate goodwill.[10]

THREE ENTITY METHOD S CORPORATION

This increasingly common business and tax structure for co-ownership involves Dr. Junior forming an S Corporation and purchasing a fractional interest in the tangible assets and goodwill from Dr. Senior or Dr. Senior's practice entity. After the purchase, Dr. Senior and Dr. Junior operate the practice through a newly formed limited liability company (LLC) 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 LLC or partnership to the corporations, which are owned by Dr. Senior and Dr. Junior, and which pay the direct business expenses of each owner. Some advisors favor this method in order to change a "tax-unfriendly" fractional purchase and sale of stock into a favorable asset purchase and sale that are all deductible to the purchaser and mostly capital gains for the seller.

If Dr. Senior's 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 Dr. Senior's personal goodwill by the practice upon Dr. Senior's buy-out, is subject to the **IRC Section 197 anti-churning rules.**

Another reason advisors favor the three entity method is that there is no co-ownership of Dr. Senior's existing practice entity, which some advisors think may carry potential liability to Dr. Junior. However, in 25-plus years of practice, I have never seen such liability to Dr. Junior. In addition, Dr. Senior and Dr. Junior are both common owners of the third entity.

THE ANTI-CHURNING RULES

If Dr. Senior's 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 Dr. Senior's personal goodwill by the practice upon Dr. Senior's 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[11] if Dr. Senior and Dr. Junior jointly own 20% or more of the third entity[12] or are family members, such as a son or daughter dentist.

It is the third entity—the LLC or partnership—that creates the problem for nonrelated owners because 20% or more common ownership makes Dr. Senior and Dr. Junior related parties. IRC Section 197 does not provide for separation of the pre- and post-August 10, 1993, goodwill.[13] The IRS is well aware of this situation and can track asset sales through Forms 8594, which must be filed by Dr. Senior, Dr. Senior's practice entity, and Dr. Junior. While there is authority under Example 19[14] 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[15] should it choose to do so, which makes me a little uncomfortable with Example 19.

If, on the other hand, Dr. Senior and Dr. Junior operate separate 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, such as 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 not required to purchase Dr. Senior's practice upon Dr. Senior's retirement, but retains the option to do so. Because the practices are separate, Dr. Senior can sell his or her 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 by a surviving or remaining practice owner. Solo group arrangements do not work well for specialty practices, although there are exceptions.

STOCK INCLUDING GOODWILL

The purchase and sale of stock in a professional corporation, including goodwill, is payable in after-tax dollars. This method should be "backed into" after an analysis that the

other two business and tax structures may pose task risks. It is the only one without any task risks and allows for a cash buy-out in a two-owner practice. 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 with after-tax or nondeductible dollars, while Dr. Senior pays tax as capital gains on the proceeds from the sale of the stock. Therefore, all taxes are accounted for and both doctors and the practice are free from IRS scrutiny in the event of an audit.

This business and tax structure works only from an economic standpoint when 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 Dr. Senior's 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, he or she only pays capital gains above the purchase price paid.

SUMMARY AND THOUGHTS

If Dr. Senior is contemplating admitting Dr. Junior as a co-owner, or Dr. Senior and Dr. Junior are now in co-ownership, understand and avoid the tax risks. If both are in co-ownership, consider revising the ownership agreements, if appropriate, to comply with the tax laws.

STOCK EXCLUDING GOODWILL

While it is a headache to calculate and monitor, compensation shifts are workable for the buy-in piece. The purchase of an undivided half interest in Dr. Senior's personal goodwill by Dr. Junior individually will not work. For the buy-out, stock excluding goodwill coupled with deferred compensation works well provided that Dr. Senior understands that the payments will be over time. Stock excluding goodwill coupled with the professional corporation's purchase of Dr. Senior's personal goodwill is viable provided that Dr. Senior does not or has 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, notwithstanding the complexity and increased accounting costs of operating three entities if the practice was formed after August 10, 1993, and the doctors are unrelated. 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.

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STOCK INCLUDING GOODWILL

My recommendation for co-ownership, especially if the practice was formed prior to August 10, 1993, is the purchase and sale of stock in after-tax dollars with a downward adjustment because the stock is not deductible to Dr. Junior, and Dr. Senior receives capital gains treatment. It is simple. There are no tax risks, and there is one entity.

Expect both of the doctor's advisors to keep the 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. **DE**

NOTES AND REFERENCES

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. Zolman C. *Tax Planning for Corporations and Shareholders*, 2nd Ed., 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; Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Comm., 109 AFTR 2d 2012, May 17, 2012.
4. Internal Revenue Code (IRC) Reg. 1.212-1; Harry R. Haury v. Commissioner, T.C. Memo 2012-215.
5. Revenue Ruling 60-31.
6. The following Technical Advice Memorandum and Revenue Ruling recognize the partial transfer of personal goodwill: TAM 200244009; Revenue Rule 70-45.
7. 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.).
8. 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. 1035768, D.C. 2:08-cv-00365-RMP.
9. The Tax Advisor, 9-09 T.T.A. 573, Elkart, Indiana: Thomas I. Broder, September 2009.
10. Kennedy v. Cir. T.C. Memo 2010-206.
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. Martin D, Ginsburg JS. *Mergers, Acquisitions, and Buyouts*. December 2002. Aspen Publications, 4118, Example 17, Section 403.4.4.4; Example 20, Section 403.4.1.4, February, 2012.
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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