

# Co-ownership In Dental Practices: It's Taxing

---



**William P. Prescott**

is a member of Wickens, Herzer, Panza, Cook & Batista's Business Organizations & Tax Department. He is a member of the Editorial Board of the Practical Tax Lawyer.

**William P. Prescott**

---

**Co-ownership can have some professional benefits, but look out for the tax risks.**

---

**DENTAL AND DENTAL SPECIALTY** practices consisting of two or more owners are becoming more common as the number of practices that grow and then expand or relocate increases. As a result, if Dr. Senior is planning to admit Dr. Junior as an owner, all parties need to be aware of the tax risks that the owners' other partner, the IRS, thinks are important under three business and tax structure choices.

Each business and tax structure consists of three categories. They are the associate buy in, the owner buy out, and operations. (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.) All categories need to be considered when co-ownership is contemplated because dealing with these complex issues a year or two after the associateship begins is likely to lead to disagreements over the purchase price, valuation date, and business and tax structure.

**PURCHASE AND SALE OF STOCK IN AFTER-TAX DOLLARS** • The first 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, Dr. Junior pays income tax on all compensation earned and then pays for the stock in after-tax or non-deductible 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 Dr. Senior, Dr. Junior, and the practice are free from IRS scrutiny in the event of an audit.

This business and tax structure only works from an economic standpoint where 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 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, Dr. Junior only pays capital gains above the purchase price paid.

### **STOCK EXCLUDING GOODWILL • Risk 1: Compensation Shifts**

The purchase and sale of stock for the buy in to a professional corporation excluding goodwill, often the fair market value of the professional corporation's tangible assets, is sometimes coupled with a compensation shift to Dr. Senior, which represents Dr. Senior's goodwill. In exchange for selling a fractional interest of Dr. Senior's goodwill, Dr. Senior receives additional compensation, often increased for the tax effect of receiving ordinary income instead of capital gains and again for an interest component, by providing administrative and management services to the practice under a practice management agreement.

Compensation shifts have not yet presented tax problems in the buy in piece of the transaction, assuming that the compensation shifted equates to the management services provided. *See* Zolman Cavitch, *Tax Planning for Corporations And Shareholders*, Second Edition, Lexis Publishing, Matthew Bender & Company, Inc., 13.04[1], [2], [3] (Matthew Bender, 2d ed. 2012); *see also* *Pediat-*

*ric Surgical Associates, P.C. v. Commissioner*, T.C. Memo 2011-81, April 2, 2001. This could change if the IRS makes an argument that the compensation shifted is a non-deductible dividend where the practice operates as a C corporation. *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Comm'r.*, 2012-1 U.S. Tax Cas. (CCH) ¶50,349 (7th Cir. 2012).

### **Risk 2: Personal Goodwill For The Buy in**

Rather than utilize a combination of stock excluding goodwill and a compensation shift, some advisors are advocating that Dr. Junior individually purchase Dr. Senior's goodwill for the buy in. This method won't work because personal goodwill is not deductible to an individual who is not a "trade or business." Reg. section 1.212-1.

### **Risk 3: Deferred Compensation**

Sometimes buy outs are structured with stock being purchased by the professional corporation excluding goodwill, coupled with the payment, over time by the practice to Dr. Senior, of deferred or continued compensation, Rev. Rul. 60-31, 1960-1 C.B. 174, 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 Code section 409A and its harsh penalties for non-compliance. The primary effects to the practice are strict rules on the payment of accounts receivable and no ability to pre-pay the deferred compensation. To Dr. Senior, the buy out is not payable in cash, but over time.

### **Risk 4: Personal Goodwill For The Buy Out**

Another buy out structure, which is supported by case law, is where Dr. Senior's stock is purchased by the practice excluding goodwill, but is coupled with the purchase by the practice of Dr. Senior's personal goodwill. (The following Technical Advice Memorandum and Revenue Ruling recognize the

partial transfer of personal goodwill: Tech. Adv. Mem. 200244009; Rev. Rul. 70-45.) To the extent that there is personal goodwill, the purchaser, which is the practice and not Dr. Junior, is able to amortize or deduct the personal goodwill over 15 years while the purchase of stock cannot be deducted. (The following recent cases recognize the existence of personal goodwill: *Muskat v. U.S.*; 554 F.3d 183 (2009); *Solomon v. Commissioner*, T.C. Memo. 2008-102 (U.S. Tax Ct. Apr. 16, 2008). To Dr. Senior, the personal goodwill should, 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. First, if personal goodwill is part of the transaction, Dr. Senior cannot be, or have a written agreement that Dr. Senior will be, subject to a restrictive covenant with the practice upon the buy out. *Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, T.C. Memo 1998-279 (U.S. Tax Ct. July 30, 1998); *Howard v. U.S.*, 2010 WL 3061626 (E.D. Wash. July 30, 2010); United States Court of Appeals for the 9th Circuit, No. 10 35768, D.C. 2:08-cv-00365-RMP. This point effectively eliminates this business and tax structure because Dr. Junior will require that Dr. Senior 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. Thomas J. Brecht, 40 Tax Advisor 573 (Sept. 2009). If this approach is used, it is important to have an appraisal that distinguishes Dr. Senior's personal goodwill versus any corporate goodwill.

**THE THREE ENTITY METHOD** • An increasingly common business and tax structure for co-ownership is for Dr. Junior to form an S corporation and purchase a fractional interest in the tangible assets and goodwill from Dr. Senior or the practice entity. After the purchase, Dr. Senior and Dr. Junior operate the practice through a newly formed limited liability company 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 limited liability company or partnership to the corporations, which are owned by Dr. Senior and Dr. Junior and which pay the direct business expenses of each owner. The three entity method may also include use of a compensation shift, the purchase of personal goodwill, questionable S corporation distributions as every dollar distributed in a limited liability company or partnership is earned income, and/or independent contractor relationships.

### **Risk 5: The Anti-churning Rules**

If Dr. Senior's practice was formed before August 10, 1993, the buy in and buy out under the three entity method, as well as the purchase of personal goodwill by the practice upon Dr. Senior's buy out, is subject to the Code section 197 anti-churning rules. The anti-churning rules deny amortization of the goodwill purchased by Dr. Junior (Code section 197(f)(9)(A)(i); Reg. section 1.197-2(h)(2)(i)) if Dr. Senior and Dr. Junior jointly own 20 percent or more of the third entity (Reg. section 1.197-2(h)(6)(i)(A)) or are family members, e.g., Dr. Senior and Dr. Junior are son or daughter dentist. It is the third entity, the limited liability company or partnership, that creates the problem for nonrelated owners because 20 percent or more common ownership makes Dr. Senior and Dr. Junior related parties. Code section 197 does not provide for separation of the pre and post-August 10, 1993 goodwill. Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts*, ¶403.4.4.4 ex. 17, at 4-110 (Aspen 2001). 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 Dr. Senior and Dr. Junior. While there is authority through Example 19 (Reg. section 1.197-2(k), Example 19) in the Code section 197 Regulations to avoid application of the anti-churning rules, there is also authority for the IRS to recast

the transaction, should it choose to do so. *See* Code section 197(f)(9)(F); Reg. section 1.197-2(h)(11). This 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, e.g., 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 usually 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.

**SUMMARY AND THOUGHTS** • Remaining a solo practitioner is best, and practicing in a solo group, second best. If Dr. Senior is contemplating admitting Dr. Junior as a co-owner or is in co-ownership, any of the three business and tax structures can work if the tax risks are recognized and not taken.

### **Stock In After-Tax Dollars**

Especially if the practice was formed before August 10, 1993, my recommendation for co-ownership is the purchase and sale of stock and after-tax dollars, with a downward adjustment because

the stock is not deductible and Dr. Senior receives capital gains treatment. It is simple. There are no tax risks, and there is one entity.

### **Stock Excluding Goodwill**

While a headache to calculate and keep track of, 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 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. If the practice was formed before August 10, 1993, the goodwill sold is not amortizable or deductible to Dr. Junior. Finally, solo group arrangements provide a good alternative, in most circumstances, to allow for goodwill to be amortized where it would otherwise not be.

Keep Dr. Senior's and Dr. Junior's other partner, the IRS, in mind when developing the business and tax structure of Dr. Senior's co-ownership for both the buy in and buy out with Dr. Junior.

To purchase the online version of this article, go to [www.ali-cle.org](http://www.ali-cle.org) and click on "online."