Partnerships:
Do those seemingly unfair tax rules still apply?

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MOST DENTAL PRACTICES have substantial goodwill.[1] Assuming that goodwill represents approximately 75%-90% of a practice sale and 10%-25% of tangible assets,[2] its deductibility is an important issue. However, there are limitations on the deductibility of goodwill in partnerships based on the date of practice formation.

SECTION 197

Case study

A professional practice was formed before August 10, 1993. Dr. Junior formed an S corporation, which purchased an undivided 50% interest in both the tangible assets and goodwill of the practice. Prior to the purchase or buy-in, Dr. Junior and Dr. Senior, who already had an S corporation, formed a limited liability company (LLC) or partnership that billed the patients, paid the operating expenses, employed the staff, sponsored the benefit plans, and distributed profits to the respective S corporations, which were members of the LLC. Profits were then distributed to Dr. Senior and Dr. Junior through their member S corporations.

Question

Can goodwill be deducted by Dr. Junior for both the buy-in and later buyout of Dr. Senior through Dr. Junior's practice entity, irrespective of the fact that the practice was formed before August 10, 1993?

Analysis

The increasingly popular arrangement used in this case study is sometimes called a three-entity method. The three-entity method is sometimes preferred because Dr. Junior can deduct both the undivided interest in the tangible assets and goodwill. Dr. Senior's S corporation or other entity receives mostly capital gains because the goodwill is valued significantly higher than the tangible assets. It's a win-win for both Dr. Junior and Dr. Senior.

However, if the practice was formed before August 10, 1993, the Section 197 rules apply if Dr. Senior and Dr. Junior jointly own more than 20% of the formed third entity.[3] Thereafter, the goodwill for Dr. Junior's buy-in and Dr. Senior's buyout by Dr. Junior's S corporation under the three-entity method is not deductible for Dr. Junior. On the other hand, Dr. Senior is unaffected by the fact that the goodwill is nondeductible for Dr. Junior because goodwill is treated as favorable capital gains to Dr. Senior, irrespective of when the practice was formed. Section 197 does not provide for separation of the pre- and post-August 10, 1993, goodwill.[4]

The Section 197 rules also apply to complete sales and purchases between family members—e.g., Dr. Senior and his or her son or daughter dentist. As a result, the goodwill is not deductible by the family member if the practice was formed before August 10, 1993.

To conclude, Section 197 is a statutory provision that only Congress can repeal, and it remains current law.[5]

PERSONAL GOODWILL FOR SHAREHOLDER BUYOUTS

Case study

A professional practice was formed prior to August 10, 1993. Dr. Senior and Dr. Junior practice through the same S corporation as equal shareholders. Dr. Junior decides that upon the future buyout of Dr. Senior, the S corporation will purchase a combination of stock and the personal goodwill of Dr. Senior, which is arguably taxed as capital gains, in lieu of paying deferred compensation, which is taxed as ordinary income, over some period of time. Restrictive covenants are in place, and there has been no appraisal of the personal versus corporate goodwill.

Question

What happens if a restrictive covenant is in place and deferred compensation, which is taxed as ordinary income to Dr. Senior, is replaced with the purchase and sale of personal goodwill?[5]

Analysis

Dr. Junior should require that Dr. Senior be subject to a restrictive covenant because, if bought out by Dr. Junior or the corporation, Dr. Senior could compete with Dr. Junior. However, if deferred compensation is replaced with personal goodwill, Dr. Senior cannot have a restrictive covenant.[6] Because of this, the use of personal goodwill in a shareholder buyout is not advisable.[7] In addition, if personal goodwill for a shareholder buyout is used, it is important to have an appraisal that distinguishes the personal goodwill from any corporate goodwill.[8]

As for Dr. Junior, if the practice was formed prior to August 10, 1993, the goodwill is not deductible due to Section 197.

Question

What if a dentist sells personal goodwill and does not file a form 8594, believing the sale of personal goodwill alone does not constitute the sale of a group of assets?

Analysis

The IRS is aware of this situation and has stated that it can track asset sales through form 8594, which must be filed by Dr. Senior, his or her corporation, and Dr. Junior.[9] The tax regulations provide that any sale of a group of assets constitutes a trade or business in the hands of either the seller or the purchaser.[10] If the selling dentist does not file a form 8594, the allocations will not match with the purchaser's allocations under the purchaser's form 8594, which could trigger an audit. There are penalties for not filing under the tax code.[11] There is also direct authority under the Section 197 regulations for the IRS to recast a transaction that attempts to avoid application of the antichurning rules.[12] Section 197 contains limited exceptions to the antichurning rules. However, use of those exceptions is limited and, in most cases, impractical.[13]

To conclude—Personal goodwill is based upon case law, which has and will continue to evolve over time.

ALTERNATIVES TO SECTION 197 AND PERSONAL GOODWILL FOR SHAREHOLDER BUYOUTS: THE EFFECT ON TAX-NEUTRAL VALUE

Two alternatives to the three-entity method and personal goodwill for shareholder buyouts are the purchase and sale of stock of a single entity, excluding goodwill or stock including goodwill, which means the value of the stock includes both tangible assets and goodwill. Both business and tax structures will dictate whether the purchase price will be increased or decreased to attain a tax-neutral fair-market value, which balances or neutralizes the tax effects to Dr. Junior and Dr. Senior. Because the three-entity method provides for asset treatment if the practice was formed after August 10, 1993, no increase or decrease to the tax-neutral fair-market value is necessary.

With stock excluding goodwill, the purchase price for the buy-in and formula for the future buyout of Dr. Senior are increased because the sale and purchase of the goodwill by the practice entity as deferred compensation is taxed as ordinary income to Dr. Senior and should include an interest component. Stock excluding goodwill represents a pretax buy-in for Dr. Junior due to the significant value of the goodwill.

With stock including goodwill, Dr. Senior receives all capital gains and Dr. Junior cannot deduct his buy-in or later buyout of Dr. Senior. Therefore, the purchase price for the buy-in and formula for the future buyout of Dr. Senior are decreased. **DE**

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